SUPREME

APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 29, 1973
CERTIORARI GRANTED JANUARY 21, 1974

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Relevant Docket Entries of Circuit Court of Appeals

United States Court of Appeals

FOR THE SECOND CIRCUIT

In the Matter

of

FREEDOMLAND, INC.,

Bankrupt,

WILLIAM OTTE,

Trustee-Appellant,

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

Appellants

Filings—Proceedings

72—Filed copies of docket entries and notice of appeal (Ottee)

72—Filed copies of docket entries and notice of appeal (USA)

72—Filed copies of docket entries and notice of appeal (City of N.Y.)

72—Filed record (original papers of district court) (& in 72-1551)

72—Filed supplemental record (original papers of district court) (& in 72-1551) (& in 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 8-15-72 (Otte) (& in 72-1551, 72-1716)

72—Filed notice of appearance (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 9-30-72 (Otte) (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 10-30-72 (Otte) (& in 72-1551, 72-1716)

Relevant Docket Entries of Circuit Court of Appeals

Filings—Proceedings

72—Filed brief and appendix, appellant with proof of service (Otte) (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant (City of N.Y.) brief to 1-3-73 (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant (U.S.A.) brief to 1-3-73 (& in 72-1551, 72-1716)

72—Filed order extending time to file appellants (U.S.A. and City of N.Y.) briefs to 1-30-73

73—Filed order extending time to file appellants (U.S.A. and City of N.Y.) briefs to 2-28-73 (& in 72-1551, 72-1716)

73—Filed brief, appellee (USA) (W/Pofs) (& in 72-1551, 72-1716)

73—Filed brief, appellee (City of N.Y.) (W/Pofs) (& in 72-1551, 72-1716)

73—Argument heard (by: Hays, Mulligan, Oakes) (& in 72-1551, 72-1716)

73—Judgment Affirmed in Part, reversed and remanded in part, Oakes, CJ (& in 72-1551, 72-1716)

73—Filed judgment (& in 72-1551, 72-1716)

73—Issued Mandate (opinion & judgment). (& in 72-1551, 72-1716)

73—Filed notice of filing of petition for writ of certiorari (S. C. #73-375) (& in 72-1551, 72-1716)

9-19-73—Original and supplemental record returned to district court

10- 4-73—Filed receipt of return of original & supplemental record to District Court

1-28-74—Filed certified copy of order of Supreme Court granting petition for writ of certiorari (& in 72-1551, 72-1716)

Order of Circuit Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the eighth day of June, one thousand nine hundred and seventy-three.

Present: HON. PAUL R. HAYS
HON. WILLIAM H. MULLIGAN
HON. JAMES L. OAKES
Circuit Judges,

72-1551

72-1716

72-1546

In the Matter

of

FREEDOMLAND, INC.,

Bankrupt,

WILLIAM OTTE,

Trustee-Appellant,

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,
Appellants.

Appeal from the United States District Court for the Southern District of New York.

Order of Circuit Court of Appeals

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court, with costs to be taxed against the appellant William Otte.

A. DANIEL FUSARO,
Clerk

by: VINCENT A. CARLIN
Chief Deputy Clerk

Decision of Circuit Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 427, 804, 805—September Term, 1972.

(Argued March 15, 1973 Decided June 8, 1973.)

Docket Nos. 72-1546, 72-1551, 72-1716

In re Freedomland, Inc.

Bankrupt.

Before:

HAYS, MULLIGAN and OAKES,

Circuit Judges.

Appeal from a judgment in the Southern District of New York, Constance B. Motley, *Judge,* (1) ordering the bankruptcy trustee to withhold taxes and file necessary forms on wages earned but not paid prior to bankruptcy; (2) assigning the taxes a fourth priority as "taxes due and owing by the bankrupt," 11 U.S.C. § 104(a)(4); and (3) denying New York City's claim for withheld taxes on the ground that the City's income tax was passed after the date the wages were earned.

Affirmed in part, reversed and remanded in part.

HOWARD KARASIK, New York, New York *for Appellant Otte, Trustee in Bankruptcy of Freedomland, Inc.*

SUSAN FREIMAN, Assistant United States Attorney (Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, on the brief) *for Appellant United States.*

SAMUEL J. WARMS, New York, New York (Norman Redlich, Corporation Counsel for the City of New York, Raymond Herzog and Cornelius F. Roche, of counsel), *for Appellant New York City.*

OAKES, *Circuit Judge*:

This case presents the esoteric, but nevertheless highly practical, issue of how withholding on wages earned before bankruptcy is to be handled in bankruptcy. Involved are both the income tax laws, silent in this regard as to the effect of bankruptcy, and the bankruptcy laws, silent as to the status of moneys withheld and indeed inarticulate as to the category of priority within which *previously* earned wages fit. The problems presented in winding a tortuous path between two inexact sets of statutes in these two different areas of law as to withholdings claimed due the United States are further complicated by virtue of a claim for income tax withholdings by the City of New York on a statute enacted *after* the wages were earned but before any payments on their account to the wage earners have been made by the bankruptcy trustee.

Freedomland, Inc., filed an arrangement petition under Chapter XI of the Bankruptcy Act on September 15, 1964, and was adjudicated a bankrupt on August 30, 1965. During the statutory period for filing claims, 413 claims of $600 or less, totaling approximately $80,000, were filed by former employees of Freedomland on account of wages earned *before* the filing of the Chapter XI petition. 11

U.S.C. § 93. No claims for withholding, social security or related taxes were filed either by the United States or the City of New York during the statutory filing period or otherwise.[1] The trustee, on November 7, 1969, moved the referee for an order authorizing payment to the wage claimants without withholding income, social security or other taxes and an order specifically declaring that he was not required (1) to make any such payments to any governmental body; (2) to prepare, distribute or file wage and tax statements for the employees or as an employer; or (3) to pay any penalties. The referee, Edward J. Ryan, was apparently much taken with the criticism by a fellow referee of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), which held that a trustee must withhold income and social security taxes and that the taxes were payable as an administration expense entitled to first priority.[2] Referee Ryan accordingly on January 27, 1971, granted the trustee's petition on all counts, holding that "compliance with withholding and reporting requirements of tax authorities

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[1] The United States had filed a claim for federal income and social security taxes due on wages *actually paid* during the quarter immediately preceding the petition for an arrangement. No claim was filed for those due on *unpaid* wages during that quarter, however, and it is withholdings on those wages which are in dispute here.

[2] *See* Hiller, *The Folly of the Fogarty Case,* 32 J. of Nat'l Ass'n of Ref. 54 (1958).

In general terms § 64(a) of the Bankruptcy Act, 11 U.S.C. § 104, categorizes debts having priority in the following order:

1. costs and expenses of administration;
2. wages not exceeding $600 earned within three months before the date of commencement of the proceeding;
3. creditor's expenses in setting aside confirmation of an arrangement or obtaining refusal of a discharge;
4. "taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof . . . ." and
5. debts owing to persons entitled to property by law.

is utterly inconsistent with the spirit and the letter of the Bankruptcy Act," particularly the policy in favor of "efficient, expeditious economic administration of bankrupt estates."

The district court took evidence on the question what administrative burdens were imposed by the requirement that taxes were to be withheld, paid over and duly accounted for by the bankruptcy trustee. The district court noted (as the referee had previously) a bankruptcy practice in the Southern District of New York, concurred in by IRS, of deducting 25 per cent of gross wage claims, covering both income and social security taxes, and paying it in one check to the Director of Internal Revenue without allocation to the various individual taxpayers. Further evidence indicated that a junior accountant or clerk with payroll records could make the 25 per cent calculations quite readily and could also fill out forms 941 and W-3 for the Government and forms W-2 for the individual employees respectively. On the basis of this evidence the district court, in an opinion printed at 341 F. Supp. 647 (S.D.N.Y. 1972), reversed the referee's order that the trustee was not required to withhold taxes or file the necessary forms. The court then went on to hold, relying upon *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), that withholdings were not "expenses of administration" as held in *United States* v. *Fogarty, supra*, but rather were entitled only to a fourth priority as taxes "legally due and owing" to the United States by the bankrupt. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4). In reaching this decision, the court also referred to *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), *cert. denied sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652 (1935), for the proposition that "before a tax could be found to be legally due and owing by the bankrupt . . . enough must have been known about the basis of the tax to make the tax computable or 'knowable' before bankruptcy, although not collectible until after ad-

judication." 341 F. Supp. at 656. As to the City of New York's claim, the district court held that since the City tax was not even enacted until 1966 [3] there were no taxes that could be said to be legally due and owing to it in September, 1964, when the Chapter XI proceeding was filed, and hence the City had no claim, under *In re International Match Corp., supra.* For the reasons which we state hereafter, we agree with the district court insofar as it required withholding and filing the prescribed forms, but disagree as to the order of priority assigned by it to withholdings, as well as to its treatment of the claim of the City of New York.

The first issue is whether a bankruptcy trustee must withhold under federal income tax law. The Internal Revenue Code of 1954, § 3401(a) defines "wages" as "all remuneration . . . for services performed by an employee for his employer. . . ." Were we to face this question afresh, an argument might be made that payments made by a bankruptcy trustee for wages earned before bankruptcy are really wage claim distributions. For example, as pointed out to us by the trustee, a solvent employer required to pay a judgment for disputed wages earned might not be paying "wages." *Cf.* Rev. Rul. 55-520, 1955 Int. Rev. Bull. No. 2 at 393-94 (compromise settlement for cancellation of employment contract not wages for withholding or FICA); Rev. Rul. 69-136, 1969 Int. Rev. Bull. No. 1 at 252-53 (sums paid former employees while in military service not wages). Further, it could be advanced that the bankruptcy trustee is not an "employer" since he has no "right to control and direct," 26 C.F.R. § 31.3401(c)-

[3] New York City has had since July 1, 1966, a tax on residents as well as nonresidents earning wages in New York that tracks the federal tax (with limited immaterial modifications), New York City Admin. Code § T46-11.0, 12.0, and contains appropriate withholding provisions. New York City Admin. Code, Ch. 46, Titles T (residents) and U (non-residents). The rate of the tax is agreed upon here as 1 per cent.

1(b), the "individual performing services," 26 C.F.R. § 31.3401(c)-1(a), that is, the wage claimant. *See In re Park Brewing Co.*, 49 F. Supp. 750 (W.D. Mich. 1942). *But see* Int. Rev. Code of 1954, § 3401(d)(1) (defining "employer" as "the person having control of the *payment of* . . . wages . . . ." [emphasis supplied]);[4] *Educational Fund of the Electrical Industry* v. *United States*, 426 F.2d 1053 (2d Cir. 1970) (payments to union members attending school which under collective bargaining agreement derived from employers but were paid out by union trust denominated as "educational fund" constituted "wages" for withholding, and educational fund held to constitute "employer" under § 3401(d)(1)).

We are not writing on a clean slate, however. *United States* v. *Fogarty, supra*, decided in the Eighth Circuit has been followed first in the Sixth, *United States* v. *Curtis*, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950), and then in the Ninth Circuits on this point. *Lines* v. *State Department of Employment*, 242 F.2d 201 (9th Cir.), *rehearing denied with opinion*, 246 F.2d 70, *cert. denied*, 355 U.S. 857 (1957). *See also In re Connecticut Motor Lines, Inc.*, 217 F. Supp. 330 (E.D. Pa.), *supplemented* 223 F. Supp. 189 (1963), *rev'd on other grounds*, 336 F.2d 96 (3rd Cir. 1964). While *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field,[5] there is no decision of any court outstanding to the contrary on the point of necessity of withholding.

Indeed, as was found below, until it was decided to make a test case of this one—and we are appalled that

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[4] The trustee suggests that he does not have "control" because payment requires an order of the court and the referee's countersignature. But the trustee applies for the order and has title to the funds to be paid, and when he sends the checks out he surely has "control of the payment."

[5] 3A Collier on Bankruptcy ¶ 64.202 at 2119 n. 1 (14th ed. 1972); Hiller, *supra* note 2.

almost nine years elapsed from the time the wages were earned until the case came to us[6]—the bankruptcy trustees, at least in the Southern District of New York, managed perfectly well with the rough deduction of 25 per cent and remittance of that sum to the Director. The trustee's and referee's parade of horribles relating to computations, employment of accountants, completion of forms, etc., was quite deflated by the court below in its findings,[7] and especially its conclusion that "Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment." 341 F. Supp. at 654. The result in Fogarty at least has the virtue that wage earners themselves do not have the job of determining their individual FICA taxes or figuring how to report them so as to obtain full social security credit therefor.

It may be that a dust cloth will be needed to wipe the cobwebs away from the files in which the wage and payroll records for the quarter in question are stored, now that so much time has gone by, but the amount of effort required on the trustee's part in a bankruptcy matter involv-

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[6] In this connection it might be noted that even the referee whose criticism of *Fogarty* was heavily relied on by the referee here refused to create a test case challenging the *Fogarty* rule in his circuit because he realized the "hardship that a protracted delay would entail" to the needy coal miners involved in his case. Hiller, *supra* note 2, at 54.

[7] The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee of the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office. 341 F. Supp. 647, 653.

ing the sums that this one does is relatively small, even though 413 wage claimants are involved. That effort probably doesn't begin to match that which will be required of a conscientious trustee to track down the present addresses of the former employees so that they may receive their long overdue wages in the mail, efforts which could largely have been avoided had distributions been made when they first could have been, several years ago. We thus hold that the trustee, as a person who substantially controls the payment of wages, Int. Rev. Code of 1954, § 3401(d)(1), is an employer for withholding tax purposes and must withhold.

It follows that as employer the trustee must file the requisite forms, including 941; W-2 and W-3, as he was ordered to do below. *Cf. Nicholas* v. *United States,* 384 U.S. 678, 692-93 (1966) (trustee in bankruptcy held under an Int. Rev. Code of 1954, § 6011(a) obligation to file returns for taxes incurred by debtor in possession). We hold also that he may withhold on the 25 per cent basis which the court below found, with no real dispute here, represents an IRS attempt to facilitate bankruptcy administration on quite a practical basis. We see no objection to this commonsense approach, for if there is an overpayment the employee can file for a refund. Of course, as income or social security taxes change—and the latter have increased .65 per cent from 1971 to 1973—the 25 per cent may have to be adjusted slightly.[8] Perhaps Congress will

[8] It should be remembered that these wage earners are in the highest degree of likelihood on the cash basis, Int. Rev. Code of 1954, § 446(a) & (c), so that the rates of tax in effect in the year of *payment* as opposed to the year of wage-earning or the year of the referee's order permitting payment govern. *Muhleman* v. *Hoey,* 124 F.2d 414, 415 (2d Cir. 1942); 2 Mertens, The Law of Federal Income Taxation § 12.42 at 179 (1973):

ultimately be of assistance here. But in any event the 25 per cent figure still seems a sound one and one easy to compute.

To which, if any, of the five priorities under § 64 of the Bankruptcy Act, note 2 *supra*, then, are withholdings on wage distributions to be assigned? The *Fogarty* case held that they should be classified as administration expenses, that is, in the first priority. *See also Lines* v. *State Department of Employment*, *supra*. But "the costs and expenses of administration," § 64(a)(1) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1), must in general relate to the preservation or development of the bankrupt's assets. *See, e.g., Adair* v. *Bank of America National Trust & Savings Association*, 303 U.S. 350, 361 (1938). We agree that the Third Circuit's criticism of *Fogarty* and *Lines* in *In re Connecticut Motor Lines, Inc.*, *supra*, 336 F.2d at 99-102, *noted*, 63 Mich. L. Rev. 1103 (1965), 40 N.Y.U.L. Rev. 360 (1965), 19 Rutgers L. Rev. 546 (1965). *See also Denton & Anderson Co.* v. *Induction Heating Corp.*, 178 F.2d 841, 843-44 (2d Cir. 1949) (commissions accruing after bankruptcy on goods ordered but not filled prior thereto held *not* entitled to first priority status). By according (a)(1) status to withholding taxes they would take priority over the wages on which they were based. In *Lines*, indeed, dividends which would have gone to wage earners were depleted by an employer's tax payment to the unemployment insurance fund. *See* 56 Mich. L. Rev. 631, 633 (1958).

The doctrine that payments of compensation are income to a taxpayer on a cash basis in the year of receipt, as distinguished from the year in which the compensation is earned, is too firmly embedded in the income tax law to permit of any question.

Withholding of social security taxes is also done "by deducting the amount of the tax from the wages *as and when paid.*" Int. Rev. Code of 1954, § 3102(a) (emphasis supplied).

We do not agree, however, with the Third Circuit's treatment in *Connecticut Motor Lines* of withholdings as "taxes which became legally due and owing *by the bankrupt*" (emphasis supplied), and hence entitled to fourth priority treatment. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104 (a)(4).[9] The taxes are by law calculable only when the wage claims are paid and not until then, note 7 *supra*, regardless of any practice by IRS to accept a flat payment of a specified percentage such as 25 per cent. The taxes were never "due and owing by the bankrupt," which was Freedomland.[10] When a tax "cannot be computed as of the date of the petition in bankruptcy," it is not "due and owing by the bankrupt." *In re International Match Corp., supra.*

We agree, rather, with the very persuasive brief of the City of New York that the proper classification for the withholdings to be made is that of second priority wage claims. All of the withholding taxes, whether federal or

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[9] The Seventh Circuit reached the same result *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955), relying somewhat on our own *Pomper* v. *United States*, 196 F.2d 211 (2d Cir. 1952). Both *Horne* and *Pomper*, however, dealt with wages actually paid before bankruptcy, not the case here. *United States* v. *Curtis*, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950).

[10] It is for this reason we reject the argument made by the Third Circuit, *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102-06 (3rd Cir. 1964), relied on by the district court here, 341 F. Supp. at 656-57, that a concerted legislative policy to reduce the priority of tax claims in bankruptcy requires a fourth priority classification for the withheld taxes here. The legislative policy discerned relates to taxes owed by the bankrupt, not by the bankrupt's employees. The fourth priority in bankruptcy relates historically and otherwise to taxes owed by the bankrupt. Similarly, the 64(a)(2) priority derives from 132 years of statutory history relating to the status of wage claims in bankruptcy, a history long precedent to the adoption in 1943 of what some will recall as "pay-as-you-go." Act of June 9, 1943, c.120 § 2(a), 57 Stat. 126, Int. Rev. Code of 1939, § 1621, as amended.

city, derive from the payments which will be made to the wage claimants. Int. Rev. Code of 1954, §§ 3402, 3101; New York City Admin. Code § T46-51.0 and § U46-8.0. The claimants are credited with the withheld amounts toward their income taxes. Int. Rev. Code of 1954, § 31(a); New York City Admin. Code § T46-53.0 and § 46-10.0. Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part. *Cf. In re Quakertown Shopping Center, Inc.*, 366 F.2d 95 (3rd Cir. 1966) (IRS can levy upon the claim of a taxpayer-creditor against a bankrupt estate without approval of bankruptcy court).

In our view when wage claims are ordered to be paid by the bankruptcy court they should be segregated and the tax monies due held as trust funds. Int. Rev. Code of 1954, § 7501(a); New York City Admin. Code § T46-55.0 and § U46-12.0. It is true that *United States* v. *Randall*, 401 U.S. 513 (1971) (5-4 decision), held that where a debtor in possession failed to obey an order of the bankruptcy court to deposit withheld taxes in a special tax account, the Bankruptcy Act's (a)(1) priority for costs and expenses of administration would override any claim pursuant to 26 U.S.C. § 7501(a) that the withheld taxes "shall be held to be a special fund in trust for the United States." *But cf. In re Airline-Arista Printing Corp.*, 267 F.2d 333 (2d Cir. 1959), and *City of New* v. *Rassner*, 127 F.2d 703 (2d Cir. 1942), referred to in *United States* v. *Randall, supra*, 401 U.S. at 519 (dissenting opinion). *Randall*, however, did not reach the question before us. Rather, it was concerned only with vindicating the Bankruptcy Act's "policy of subordinating taxes to costs and expenses of administration." 401 U.S. at 517. That policy is fully upheld by placing the withheld taxes here in a second priority position along with the wages that create

them. In other words, the trust which arises is subject to the prior payment of the statute-specified costs and expenses of administration, but exists nevertheless as to withholdings on wage claims allowed.[11] In this view, contrary to the view of the Third Circuit in *Connecticut Motor Lines, supra,* 336 F.2d at 107, there is no necessity for the Government (or City) to file proofs of claims for withholdings. Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt,* not the case here. The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. In this respect we agree with the court below.

There remains for consideration only the question whether New York City may obtain withholding taxes on the wage claims paid since there was not even a city income tax in effect when the wages were earned. But we have already pointed out that the wage earners here are in all probability on the cash basis, note 7 *supra,* so that regardless of when the wages were earned, they are income and taxable in the year received. As we have already said, liability for withholding arises when the wage claims are paid. Int. Rev. Code of 1954, §§ 3402, 3101 and 31(a). The City in this respect is in the same position as

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[11] The second sentence of § 7501 of the Int. Rev. Code of 1954 is consistent with this view:

> . . . The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to taxes from which such fund arose.

the federal government. New York City Admin. Code §§ T46-51.0 and U46-8.0; §§ T46-50.0 and U46-10.0. Wages are just as much a part of city "adjusted gross income," New York City Admin. Code § T46-12.0, as they are of federal. The fact that the city tax applies to wages earned before its effective date is not important since no vested rights are impaired. *See Welch* v. *Henry*, 305 U.S. 134, 146-51 (1938); *Milliken* v. *United States*, 283 U.S. 15, 20-24 (1931); *Kentucky Union Co.* v. *Kentucky*, 219 U.S. 140, 152-53 (1911) ("Laws of a retroactive nature, imposing taxes . . . and not impairing vested rights, are not forbidden by the Federal Constitution"). *See also Lynch* v. *Hornby*, 247 U.S. 339 (1918) (federal income tax law constitutionally permits taxation of dividends paid out of surplus accumulated before date of act); *Neild* v. *District of Columbia*, 110 F.2d 246, 253 (D.C. Cir. 1940). We conclude that the City is as entitled to its withholding tax as the federal government is to its taxes.

We add only that to the extent there is now a conflict among the circuits as to priorities of withholding taxes on pre-bankruptcy wages earned—the Eighth and Ninth Circuits going for the first, the Third for the fourth and the Second for the second—correction may come either from Congress or the High Court. It is a pity that the wage claimants here had to wait so long for the case to wend its way to our court, and that so many of them were involved. Nevertheless the question has some significance in the administration of bankrupt estates so that it is perhaps well that after the 25 years that have elapsed since *Fogarty* the matter might receive some further congressional or judicial attention.

We reverse and remand for the entry of judgment in accordance with this opinion.

Relevant Docket Entries of District Court

United States District Court

FOR THE SOUTHERN DISTRICT OF NEW YORK

64—B—727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Bankruptcy Court

9/15/64—Filed petition, schedules, statement of affairs, statement of executory contracts and affdvt. of Hyman Green pursuant to Rule XI-2—referred to Referee Ryan.

8/30/65—Referee signed Order of Adjudication and Approval of Appointment of Trustee, (William Otte) ($100,000.00).

12/ 7/65—Referee signed Order Barring filing of Administration claim to January 30, 1966 (with Trustee).

11/ 7/69—Filed N/M for order authorizing payment of wage claims without deduction for payroll taxes, etc. returnable November 17 at 10:00.

6/16/70—Filed reply memorandum of The City of New York in re: withholding of taxes from priority wage claims to be paid.

1/28/70—Filed Referee's decision on Trustee's application with respect to wage claims.

Relevant Docket Entries

2/26/70—Referee signed order directing Trustee to declare dividend upon class 2 Priority wage claims etc.

3/ 2/70—Filed Petition to Review re: order signed 2/26 directing Trustee to declare dividend upon Class 2 Priority Wage claims, etc.

3/ 5/70—Filed Referee's certificate on petition for review.

3/ 5/70—Filed affidavit of service re: order signed on 2/26/71.

District Court

3/ 9/71—Filed referee's certificate on petition for review. Ret. 3-23.

3/ 9/71—Filed one portfolio on petition for review, to be returned to Referee.

3/11/71—Filed application for order to show cause restraining the trustee from making distribution on wage claims until Govt's petition for review of referee's order is decided . . . BONSAL, J. ret. 3-16-71.

3/16/71—Filed memo endorsed on order to show cause "Motion granted no opposition. So ordered. Bonsal, J."

4/19/71—Filed memorandum of law of City of N.Y. on its petition for review.

4/21/71—Filed memorandum of law by the U.S. in support of its petition for review.

2/29/72—Filed opinion #38292 * * * petition to review Nov. 7-69 the trustee moved before the referee for an order authorizing him to pay 413 priority wage claimants without withholding there from U.S. N.Y. STATE OR N.Y. CITY income taxes.

This relief was granted. * * * the decision and order of referee are reversed * * * Submit order on five days notice . . . MOTLEY, J. . . . copy sent to Referee.

3/ 2/72—Received from Clerk of Court copy of Judge Motley's opinion. Re: Federal Withholding Taxes.

3/ 6/72—Filed transcript dated Jan. 20-21-1972.

3/23/72—Filed Order that * * * the petition by the City of N.Y. to review the referee's order of 2-26-71 is denied, and ordered that the petition by the U.S. to review the referee's order of 2-26-71, be and it hereby is granted * * * Motley, J.

3/24/72—Received from Clerk of Court copy of Judge Constance B. Motley's order re: granting referee's order of 2/26/71.

4/18/72—Filed notice of appeal from order of Judge Motley, dated March 22, (and filed in the Clerks Office March 23, 72) denying the petition by the City of New York to Review the order of Judge Ryan—filed by: Howard Karasik, Atty for William Otte, Trustee in Bankruptcy of Freedomland, Inc., Bankrupt—1290 Ave of Americas, NYC—

4/19/72—copies mailed to: Susan Freiman, Esq. Asst. U.S. Atty, U. S. Courthouse, Foley, NY—Atty for the U.S. Government.

Raymond Herzog, Esq. Asst. Corp. Counsel, Municipal Building NYC. Atty. for the City of New York.

Louis J. Lefkowitz, (Atty for State of N.Y.) Attorney General, State of New York, State Office Building, 80 Centre St., NYC (Copies mailed on 4-19-72).

5/ 2/72—Filed notice of appeal from so much of the order of Judge Motley in this proceeding dated March 22, 72, and entered in the Clerk Office on March 23, 72, as gives the Federal withholding taxes a priority under Section 64a(4) of the Bankruptcy Act, filed by Susan Freiman, AUSA.

US Atty for the Southern District
Foley Square, NYC

5/ 3/72—Copies Mailed 5-3-72 to
Raymond Herzog, Esq. Asst. Corp. Counsel, Municipal Bldg, NY &

Louis J. Lefkowitz, Atty General, State of NY, State Office Bldg, 80 Center St., NYC &

Howard Karasik, Esq. 1290 Ave. of Americas, NYC &

David Shandalow, Esq., 1501 Bway, NYC

5/19/72—Filed notice of appeal from so much of the order of Judge Motley dated March 22, 72 and entered in the Clerk's Office on March 23, 72, (1) denying the petition by the City of NY to review the order of Referee Ryan dated Feb. 26, 71 and (2) giving the federal withholding taxes only a fourth priority under Sec. 64a (4) of the Bankruptcy Act, filed for: J. Lee Rankin, Corp. Counsel of the City of N.Y. Atty for the City of NY . . . by Raymond Herzog, Asst. Corp. Counsel . . . Office and PO Address: Municipal Bldg NYC.

3/22/72—Copies Mailed on May 22, 72 to:

Howard Karasik, Esq. Atty of Trustee,
1290 Ave. of Americas, NYC

Relevant Docket Entries

Whitney North Seymour, Jr.
US Atty for S.D. of N.Y.
U.S. Courthouse, Foley Square, NY

Hon. Louis J. Lefkowitz, Atty General of the State of NY
80 Centre St., NYC

David Shandalow, Esq. Atty for Bankruptcy Lawyers Bar Asso.
1501 Broadway, NYC

Clerk of the U.S. Court of Appeals for the Second Circuit
U.S. Courthouse, Foley Square, NYC.

5/23/72—Received notice from Howard Karasik, Atty for Trustee that record on appeal has been certified and transmitted to the U.S. Court of Appeals 5-23-72.

6/27/72—Filed Stipulation that it is hereby agreed, by and among the attorneys for the respective appellants that the attached copies of the following documents (the originals of which were heretofore filed in this Court on the date set after the name of the document, but which cannot now be found among the Court's records despite diligent search therefor) be substituted for the missing originals and included by the Clerk of the Court in a supplemental record to certified and transmitted to the Second Circuit.

6/27/72—Rec'd. notice that supplemental record on appeal has been certified and transmitted to the U.S. Court of Appeals for Second Circuit on June 27, 1972.

Petition in Proceedings Under Chapter XI

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

64—B—727

In the Matter

—of—

FREEDOMLAND, INC.,

Debtor.

SCHEDULE A.—STATEMENT OF ALL DEBTS OF DEBTOR

Schedule A-1

Statement of all creditors to whom priority is secured by the act.

Claims which have priority.	Reference to ledger or voucher.	Names of creditors.	Residences (if unknown, that fact must be stated.)	When and where incurred or contracted.	Whether claim is contingent, unliquidated or disputed.	Nature and consideration of the debt, and whether incurred or contracted as partner or joint contractor and, if so, with whom.	Amount due or claimed.
a. Wages due workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the debtor, to an amount not exceeding $600 each, earned within three months before filing the petition.		There are approximately $80,000 in wages due employees as set forth in the debtor's payroll records for the four-month period immediate preceding the filing.					$80,000.00

Notice to File Claims

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Bankrupt. No. 64B727.

In the Matter

—of—

FREEDOMLAND, INC.,

NOTICE TO FILE CLAIMS

NOTICE IS HEREBY GIVEN that pursuant to an order made by HONORABLE EDWARD J. RYAN, Referee in Bankruptcy, dated December 7, 1965, all persons, firms, corporations, taxing authorities and agencies having claims against the above named bankrupt estate, the debtor-in-possession or the trustee, arising subsequent to the filing of the petition for arrangement under Chapter XI of the Bankruptcy Act on September 15, 1964, be and they hereby are directed to file with MARTIN J. CAINE, attorney for the trustee, at 280 Madison Avenue, Borough of Manhattan, City of New York, on or before January 30, 1966, an affidavit properly sworn to, setting forth the nature and amount of such claims, the dates when such claims were incurred and created, and specifically setting forth that such claims arose subsequent to the date of the filing of the petition for arrangement under Chapter XI of the Bankruptcy Act on September 15, 1964, and prior to the date of adjudication on August 30, 1965, and that upon the failure of such firms, persons, corporations, taxing authorities, or taxing agencies, to file such claims on or before said date, they be precluded and forever barred from making any claim thereafter

against the estate of the above named bankrupt or against the funds in the hands of the trustee, or against the trustee.

CLAIMS FOR OBLIGATIONS INCURRED BY THE BANKRUPT PRIOR TO SEPTEMBER 15, 1964 WERE REQUIRED TO BE FILED BY APRIL 15, 1965. IF YOU HAVE ALREADY FILED CLAIMS FOR AN OBLIGATION INCURRED PRIOR TO SEPTEMBER 15, 1964, IT IS NOT NECESSARY TO FILE ANOTHER CLAIM AT THIS TIME. CLAIMS FOR OBLIGATIONS INCURRED AFTER SEPTEMBER 15, 1964 WHICH HAVE ALREADY BEEN FILED WITH THE REFEREE IN BANKRUPTCY OR THE TRUSTEE NEED NOT BE FILED AGAIN.

December 7, 1965

WILLIAM OTTE, Trustee

MARTIN J. CAINE
Attorney for Trustee
280 Madison Avenue
New York, N. Y. 10016

Decision on Trustee's Application with Respect to Wage Claims

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

In Bankruptcy No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Before: HONORABLE EDWARD J. RYAN,
Referee in Bankruptcy.

MARTIN J. CAINE, Esq.,
280 Madison Avenue
New York, New York
Attention: HOWARD KARASIK, Esq.

HONORABLE WHITNEY NORTH SEYMOUR, JR.
United States Attorney for the
Southern District of New York
United States Courthouse, Foley Square
New York, New York
Attention: Miss SUSAN FREIMAN
Assistant United States Attorney

HONORABLE J. LEE RANKIN
Corporation Counsel of the
City of New York
Municipal Building
New York, New York
Attention: CORNELIUS ROCHE, Esq.
Assistant Corporation Counsel

Decision on Trustee's Application with Respect to Wage Claims

HONORABLE LOUIS J. LEFKOWITZ
Attorney General of the
State of New York
80 Centre Street
New York, New York

Freedomland, Inc. filed its petition in proceedings for an arrangement under Chapter XI, Section 322, of the Bankruptcy Act on September 15, 1964. At the first meeting of creditors, held on October 15, 1964, William Otte was nominated as the person to be appointed trustee in bankruptcy if it should become necessary to administer the estate in bankruptcy. The arrangement proceedings did fail and, on August 30, 1965, the debtor was adjudicated a bankrupt. Mr. Otte qualified by filing his bond and commenced upon the administration of the estate.

Mr. Otte, the trustee in bankruptcy, now moves for an order:

"1. Authorizing and directing the trustee, upon the declaration of a dividend upon class (2) priority wage claims in this proceeding, to distribute to such claimants the full amount of their respective claims as filed and allowed, without withholding or deduction of United States income or social security taxes.

2. Declaring that the trustee is not required under law to

(a) withhold or deduct from any distribution of a dividend to class (2) priority wage claimants income withholding, social security, or any other payroll taxes claimed by the United States, the State of New York, or the City of New York;

(b) to pay to the United States, the State of New York, or the City of New York, any amounts whatever in connection with the distribution of a dividend upon class (2) priority wage claims, other than such amounts as are set forth in a class (1) administration expense claim or a class (4) priority tax claim filed and allowed in this proceeding;

(c) to file any report or tax return with the taxing authorities of the respondents in connection with the distribution of a dividend upon class (2) priority wage claims;

(d) to prepare or distribute to class (2) priority wage claimants, or to file with the taxing authorities of the respondents, wage and tax statements (forms W-2, etc.) in connection with the distribution of a dividend upon class (2) priority wage claims;

and declaring that the trustee, individually and as such trustee, shall have no liability whatsoever to any of the respondents by reason of any alleged failure to perform any of the functions set forth in subparagraphs '(a)', '(b)', '(c)' and '(d)'.

3. For such other relief as is proper."

This application is made on notice to the United States Attorney for this District, the Attorney General of the State of New York and the Corporation Counsel of the City of New York.

The application of the trustee, *in extenso*, except for the formal parts, is as follows:

Decision on Trustee's Application with Respect to Wage Claims

"1. Applicant has applied for an order declaring a dividend class (2) priority wage claims filed and allowed in this proceeding.

2. By directive issued to Referees in Bankruptcy, the Internal Revenue Service of the United States has set forth that upon distribution of a dividend to any class (2) priority wage claimant, trustees in bankruptcy are required to:

(a) either ascertain the exact amount of United States income and social security taxes required to be withheld and deducted from such distribution and to withhold and deduct such amounts;

(b) or, alternatively, to deduct 25% of any such distribution on account of United States income and social security taxes;

(c) to file forms 941 with the Internal Revenue Service for any amounts withheld and deducted upon such distributions and to pay to the Internal Revenue Service such amounts withheld and deducted;

(d) prepare and distribute to wage claim distributees and file with the Internal Revenue Service wage and tax statements (forms W-2).

3. Applicant submits that the requirements imposed by this directive are contrary to law for the reasons that:

(a) the distribution of a dividend upon a class (2) priority wage claim filed and allowed in a bankruptcy proceeding is not the payment of wages within the meaning of Internal Revenue

Code Section 3401, et seq., or within the meaning of any other governing provision of United States or New York law;

(b) in any event the provisions of the Bankruptcy Act governing the filing and allowance of and distribution upon claims of the United States against the bankrupt estate supervene any conflicting provisions of the Internal Revenue Code and Regulations.

4. Applicant requests the entry of an order clarifying and determining the responsibilities of the trustee with respect to the onerous functions imposed by the directive, for the following reasons germane to the administration of this estate:

(a) There are 413 class (2) priority wage claims filed in this proceeding. The preparation of tables of distribution, the preparation and filing of forms 941, reporting withholding and deductions for each distributee, and the preparation and distribution to the distributees of forms W-2 in each case, would impose a massive burden upon the administration of this estate, to the detriment of its creditors, since applicant would be obliged to incur substantial expenses for accounting and legal services which would otherwise be unnecessary.

(b) As a practical matter, it would be impossible for the trustee to ascertain the exact United States payroll deductions in the case of each of the 413 priority wage claims filed in this proceeding. Even if it were possible to ascertain this data in every such case, the expense of such ascertainment would impose an addi-

tional massive and onerous burden upon the administration of this estate and substantial additional expense.

(c) Applicant believes that the alternative deduction of 25% would constitute a substantial tax over-payment to the United States in the case of 98% or more of the priority wage claimants in this proceeding. It has been applicant's experience that the preponderance of priority wage claim distributees in bankruptcy proceedings who are entitled to refunds of taxes withheld by bankruptcy trustees never in fact apply for or obtain such refunds. The inevitable end result is the imposition of hardship or partial loss upon such distributees with consequent improper windfall to the United States. Applicant believes this result is contrary to public policy and to law. As trustee, applicant is charged with the responsibility of the protection of the common interests of a class of creditors of the estate against hardship or loss sustained pursuant to a directive which is contrary to public policy and to law.

5. The State and City of New York have been made parties respondent to this application, since applicant believes that under prevailing law the rights of each to deduction, remittance, and reporting of withholding taxes upon class (2) priority wage claim distributions are not less than those of the United States, and it is necessary that the trustee obtain a declaration that neither applicant as trustee nor the estate has any obligation to perform such functions to or for any taxing authority."

Decision on Trustee's Application with Respect to Wage Claims

In its answer, the United States admits the allegations of paragraphs 1 and 2 of the trustee's application; denies the allegations of paragraph 3 and admits so much of paragraph 4 as alleges that there are 413 priority wage claims which have been filed. The United States contends, in paragraph 4 of its answer, that:

> "4. The trustee is required by law to withhold taxes from distributions to wage claimants, to file with the Internal Revenue Service information returns (Form 941) reporting such withholding, and to transmit to wage claimants statements reporting such withholding (Forms W-2)."

And, finally, the United States in the fifth paragraph of its answer contends that this court has no jurisdiction to pass on this matter, and that it is without jurisdiction prospectively to absolve the trustee from potential liability for failure to withhold and report.

The State of New York defaulted in appearing and in pleading to the application of the trustee.

The City of New York, by answer, admits the allegations contained in paragraphs numbered 1, 2 and 5 of the trustee's application. The City also denies the allegations contained in the third numbered paragraph of the application, and it alleges that it is without knowledge or information sufficient to form a belief with respect to the allegations contained in paragraph numbered 4, except that the City of New York admits that the trustee requests the entry of an order authorizing payment of wage claims without deduction of payroll taxes. For a "Second Defense" the City of New York:

> "4. Alleges that William Otte, trustee in bankruptcy, is required

(a) to deduct and withhold from any distribution of a dividend to wage claimants the New York City Personal Income Tax and/or the New York City Earnings Tax due upon such payments of wages;

(b) to file a return and forward a correct remittance to the New York City Income and Excise Tax Bureau in payment of the income and/or earnings taxes required to be withheld as aforesaid;

(c) to furnish to the aforesaid wage claimants and to the New York City Income and Excise Tax Bureau completed copies of the City of New York Wage and Tax Statement (Form NYC-2); and

(d) to comply with all other requirements for withholding tax from wages under the New York City Personal Income Tax on Residents (Title T of Chapter 46 of the Administrative Code of the City of New York) and the New York City Earnings Tax on Nonresidents (Title U of Chapter 46 of the Administrative Code of the City of New York)."

A scrutiny of these pleadings shows that they raise no issues of fact but, rather, that "an issue of law" is raised. The respondents' controverting of the "allegations" of paragraph 3 of the application merely argues the conclusion of law contained in that paragraph. The respondents' admission of the allegations contained in paragraph 2 of the application does not establish the "fact" stated therein; the Internal Revenue Service of the United States has not undertaken to define the duties of trustees in bankruptcy, "[b]y directive issued to Referees in Bankruptcy, ..." The duties of trustees in bankruptcy are defined, *inter alia*, in Bankruptcy Act, Section 47, and General Order in Bankruptcy 17, adopted by the Supreme Court of the United States.

Decision on Trustee's Application with Respect to Wage Claims

To the extent that it might be said that issues of fact were raised by reason of the denial of the allegations contained in paragraph 4 of the application, the parties declined the invitation of the court to adduce evidence and, instead, relied upon "the law".

It appears, then, that on a most meager record, the undersigned is called upon to determine as a "matter of law" which of two clearly desirable, but countervailing objectives is to be preferred, viz., the collection of taxes or the efficient inexpensive administration of estates in bankruptcy. Compare the analogous problem presented by the contentions of the litigants in *United States* v. *First National City Bank,* 396 F.2d 897 (2d Cir. 1968) ["bank secrecy"].

The argument that this court is without jurisdiction is without merit. In the instant case, the trustee in bankruptcy requests directions from the court so that he may fulfill his statutory duty to ". . . collect and reduce to money the property of the estates for which they are trustees, *Under the direction of the court,* and close up the estates as expeditiously as is compatible with the best interests of the parties in interest; . . . ." Bankruptcy Act, Section 47a (1). Such directions of the court may be implemented by ". . . such orders . . . as may be necessary for the enforcement of the provisions of this Act; . . . ." Bankruptcy Act, Section 2a (15). Alternatively, the tax authorities might be deemed to have filed contingent, unliquidated claims for taxes in their papers submitted in the instant controversy, and the court clearly has jurisdiction to determine the validity of such claims. Bankruptcy Act, Section 2a (2), 2(A).

Decision on Trustee's Application with Respect to Wage Claims

The gist of this controversy is whether a trustee in bankruptcy is an "employer" who is paying "wages" when he makes a distribution to wage claimants who are entitled to priority in distribution of estate assets by virtually Section 64a(2) of the Bankruptcy Act, so that as such "employer" the trustee is required to comply with the applicable withholding and reporting provisions of the Federal, State and City tax laws.

The tax authorities rely primarily upon the rule of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947) and its progeny including *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. den.* 339 U.S. 965 (1950), and *In re Daigle,* 111 F.Supp. 109 (D.C., Maine, 1953). Clearly, *Fogarty* supports the position taken by the tax authorities in the instant case. For the reasons hereinafter stated, I have concluded that *United States* v. *Fogarty* was wrongly decided. I am of the opinion that I am not bound by that or any other controlling decision. *Fogarty* was mentioned in passing in this Circuit in *Educational Fund of the Electrical Industry* v. *United States,* 426 F.2d 1053 (2d Cir. 1970). In mentioning this case, however, the Court of Appeals for this Circuit merely cited *Fogarty* for the proposition that:

> "The purpose of Section 3401(d)(1) is to provide that the person actually paying the wages (instead of the employer who makes a payment into a fund for the benefit of all his employees) is obligated to withhold the taxes."

Educational Fund of the Electrical Industry was essentially a "tax" case without bankruptcy or other competing federal over-tones which are found in the instant controversy.

Decision on Trustee's Application with Respect to Wage Claims

In my opinion, the basic vice of *Fogarty* was its consideration of the problem before it merely as a tax case, without giving due regard to the consequences to orderly, efficient, economical bankruptcy administration which necessarily ensue from that ruling. Little can be added to the lucid criticism of *Fogarty* by Referee Russell L. Hiller of Reading, Pennsylvania, in a paper entitled, "The Folly of the Fogarty Case" which was read at the Annual Conference of the National Association of Referees in Bankruptcy at Indianapolis on October 28, 1957.[1] As Referee Hiller pungently states:

> "In practice, as any Referee knows, the application of the Fogarty rule is sheer nonsense."

To apply the *Fogarty rule* in every bankruptcy case would impose a further burden on the administration of these estates which is entirely inconsistent with the objective of efficient expeditious economic administration of bankrupt estates.

Fogarty has been criticized even in authorities upon which the tax authorities in the instant case rely. In *In re Connecticut Motor Lines, Inc.*,[2] Judge Foreman said, *inter alia*:

> "The ultimate result in *Fogarty* rests on a number of cases which lend little support to that holding, and if anything, detract from the reasoning of the Eighth Circuit (footnote omitted)."

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[1] 32 Journal of the Nat'l Ass'n of Referees in Bankruptcy 54, April 1958 (photocopy annexed).

[2] 336 F.2d 96, 99 (3d Cir. 1964).

Decision on Trustee's Application with Respect to Wage Claims

In *United States* v. *Klein*,[3] the court observed: "We are not impressed with the reasoning of the court in the Fogarty case. . . ."

In practice, except in rare cases, no trustee in bankruptcy complies with State and City withholding and reporting requirements in the Southern District of New York at the present time. Again, except in rare instances, trustees in bankruptcy do not attempt to comply with Federal reporting requirements. In effecting distribution to wage claimants, 25% of the gross wage claims being paid is deducted and transmitted by one check to the Director of Internal Revenue without attempt to allocate the proportion of such "withholding tax" to the various wage claimants for appropriate credit. The origin of this practice was not explained in the instant proceedings. The record is also barren of any evidence of what is the practice in other districts.

I am of the opinion that compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and the letter of the Bankruptcy Act. Accordingly, I hold that a trustee in bankruptcy is not an employer who pays wages when he distributes dividends on account of wage claims, whether priority or general.

Settle an appropriate order consistent with the foregoing.

Dated: New York, New York
January 27, 1971.

/s/ EDWARD J. RYAN

EDWARD J. RYAN
Referee in Bankruptcy

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[3] 220 F.2d 33, 35 (7th Cir. 1955).

Journal of the Folly of the Fogarty Case *

By REFEREE RUSSELL L. HILLER, Reading, Pa.

When your President, Lee Cazort, invited me to participate in your program, I pondered the question of what I might speak upon that would add a modicum of substance and interest to your program. I found the answer in my own experience as a referee. That experience involved the application of the rule and authority of the case of *U. S.* v. *Fogarty,* a case decided in 1947 by the United States Circuit Court of appeals for the 8th Circuit. My experience convinces me that the holding in that and the several cases that have since followed in its wake, are erroneous and unsound and their rule ought to be changed. As I view it, that change at this late date will have to be made through legislation.

It is now 10 years since the case of *U. S.* v. *Fogarty* was decided. During that period the principle established by that case has taken root. In 1949 the 6th Circuit followed in the case of *U. S.* v. *Curtis.* In 1953 the District Court in Maine (1st Circuit) followed with *In re Daigle.* In 1955 the 7th Circuit in *U. S.* v. *Klein* distinguished the Fogarty case on its facts; and in 1957 in the case of *Matter of Blackwood* the 9th Circuit extended the rule of the Fogarty case to a state tax claim. The time has arrived for some effective action to set aside the rule of the Fogarty case. That is the only reason I burden you with a discussion; for most of you are already familiar with the undesirable aspects of the rule of that case and how impracticable and burdensome is its application.

Briefly stated, *U. S.* v. *Fogarty* stands for the proposition that in making distribution on wage claims filed for prebankruptcy wages a trustee in bankruptcy is required to make appropriate deductions for income withholding taxes and social security taxes due the United States, which deductions are payable as an administration expense entitled to priority.

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* Paper read at Referees' Indianapolis Conference (Oct. 28, 1957).

In practice, as any Referee knows, the application of the Fogarty rule is sheer nonsense. Let me illustrate from my own experience.

In 1954 Hammond Coal Company, a Pennsylvania Corporation, was adjudged bankrupt. It conducted extensive coal mining operations in the anthracite coal fields in Pennsylvania under a lease from the Stephen Girard Estate in Philadelphia. The Girard Estate owned the mines. Hammond's property holdings were modest. Virtually the only tangible assets available for liquidation were 110 carloads of processed coal already in cars and some processed coal, stockpiled on the premises. Liquidation produced a fund of about $100,000.00. At the time of bankruptcy the company employed nearly 800 persons, to each of whom it owed wages earned within the statutory priority period. This resulted in nearly 800 wage claims being filed aggregating in excess of $200,000.00.

The Director of Internal Revenue at Philadelphia filed claims for income withholding, federal insurance contributions and federal unemployment taxes aggregating $491,000.00. At the audit of the trustee's account counsel for the Regional Director's Office at Philadelphia appeared and urged that in making distribution on each of the foregoing wage claims the trustee first make appropriate calculations and deductions for withholding and employment taxes, citing *U. S.* v. *Fogarty* (*supra*). The trustee protested the request as unreasonable and burdensome, urging (1) that neither he nor the Bankruptcy Court had at its disposal the staff and facilities necessary to perform the calculations involved, which included an examination of the withholding exemption statements of each employee; (2) that the hire of necessary skilled help to perform the task was unjustified as constituting an unwarranted financial burden to the estate, and (3) in any event, it appeared probable, if not a certainty, that the taxes thus paid would in turn be largely, if not entirely, recovered by the taxpayer

by way of tax refunds, since the bankruptcy occurred in the early part of the calendar year in 1954 and many claimants were still unemployed. As my Circuit, the 3rd, had not had occasion to pass upon this question, I was disinclined to accede to the government's request. Counsel for the Regional Director advised that refusal would result in review and appeal if necessary. With nearly 800 needy coal miners eagerly awaiting a payment on their wage claims, I acceded to the government's request in order to avoid the hardship that a protracted delay would entail. To accomplish the task, I authorized the hire of the bankrupt's former Comptroller, who was familiar with the payroll, to calculate the taxes and prepare a schedule of net payments due each wage claimant and the tax thereon due the United States. That task cost the estate over $600.00 and resulted in a gross payment to the United States of $1,611.41 for withholding and $1,761.72 for employment taxes!

This practical application of the principle of the Fogarty case in my view demonstrates in a dramatic way the folly and utter absurdity of the rule of that case.

I will not attempt to reargue the Fogarty case. That would be futile. It is too late to follow such a course. What is needed at this late date is legislation; an amendment to Section 64 of the Bankruptcy Act providing specifically for an exclusion from tax deductions on payments of all wage claims, whether priority or general. However, I am not concerned here with the mode of amendment as much as I am with the need for it.

But I have not told you the whole story about the Fogarty case. It stands for more than the briefly stated proposition mentioned earlier. Let me review it and its progeny cases for you a bit more in detail. In doing so, substance will be added to what is so far only premise.

The Fogarty case had its inception in December 1942 when Inland Waterways, Inc. filed a Chapter X petition.

At the time the Company employed 200 persons and did shipbuilding for the U. S. Navy in the vicinity of Duluth, Minn. It owed wages to its employees earned within the priority period approximating $44,000.00, for which claims were later filed. Fogarty was appointed trustee with power to continue the business until a plan of reorganization could be devised and approved or until adjudication, should that become necessary. Operations did not prove feasible and were ultimately discontinued. In June 1945 the Company was adjudged a bankrupt. The Court thereafter ordered a 25% dividend to be paid to wage claimants. At this juncture the Collector of Internal Revenue demanded that in making such distribution the trustee file returns, withhold and pay Federal Insurance Contributions taxes and Income withholding taxes. The trustee declined, whereupon the Collector filed with the bankruptcy court a claim for such withholding taxes as an expense of administration Review and appeal followed. Without burdening the discussion with tedious detail regarding a government set-off and other extraneous facts, the Court on appeal sustained the government's position, in the course of which it reached the following conclusions:

(a) The assessment of employment taxes on wage dividends is valid.

(b) For such purpose a trustee in bankruptcy is an "employer" within the meaning of the relevant taxing statutes.

(c) Under the relevant taxing statutes, the term "employer" applies [to a bankruptcy trust as an] employer under the income withholding tax provisions of Internal Revenue Code, and is liable for the payment of taxes applicable to such wages.

(e) The amounts distributed by the trustee to wage claimants, constitute "wages" within the meaning

of the social security employment tax statutes and provisions of Income withholding tax statutes.

(f) Dividends to wage claimants do not lose their identity as "wages".

(g) The term "employer" as used in Treasury Regulations referable to income withholding taxes means the person paying such wages or having control of their payment.

(h) Social Security employment taxes as well as Income withholding taxes are payable as an expense of administration having priority, with respect to wages *earned* prior to the employers bankruptcy, and *paid* by the trustee under Court Order, because such taxes were not due and payable at the time bankruptcy proceedings were instituted, but only "as and when wages were paid".

Even a casual analysis of these propositions established in the Fogarty case renders it obvious that in rationalizing the problem before it, the Court was oriented in its thinking almost entirely to the taxing statutes and not at all to the Bankruptcy Act, especially to its provisions concerning priorities of payment.

Probably the most tenuous of all the propositions established in the Fogarty case are (1) that distributions made by a trustee to wage claimants constitutes "wages"; and (2) that the trustee in making distribution to wage claimants is an "employer" within the meaning of certain tax statutes. These propositions of course were essential to enable the Court to reach the result.

But I will not belabor the flimsy premises which the Court employed to support its reasoning and result. My purpose is directed more to show how the rule of the Fogarty case has grown and how unwise it is to permit it to remain in our system of jurisprudence.

Two years after the Fogarty case came the case of *U. S.* v. *Curtis* (*supra*). The Circuit was the 6th; the Bankrupt was Forest City Brewing Co.; the trustee was Curtis; and the Referee, Friebolin. The government, relying upon the Fogarty case, requested that deductions for income withholding taxes be made by the trustee on payments to wage claimants for wages earned before bankruptcy. The trustee declined; the referee disallowed the claim; on review the District Court affirmed and on appeal the Circuit Court reversed. On appeal, there was no appearance by the trustee. Despite that, however, the holding in the Fogarty case that such taxes are enforceable against the estate of the bankrupt as an expense of administration having priority, was just too much for the Court. Instead it expressly refrained from "reaching the question, base its decision or express any opinion" upon that portion of the Fogarty decision. Accordingly, in the Curtis case the withholding on wage dividends was approved, but the amount withheld was assigned a fourth priority only under Section 64.

The opinion of Referee Friebolin in the Curtis case is devastating in discrediting the propositons and reasoning in the Fogarty case and I commend it to your reading.

Next in 1953 was the U. S. District Court in Maine (1st Circuit) in the case of *In re*: *Daigle* (*supra*), where the Court embraced the rule of *U. S.* v. *Fogarty* completely.

And so the ball was rolling, gathering momentum as it rolled on, until its progress was somewhat impeded by the holding of the Circuit Court for the 7th Circuit in 1955 in *U. S.* v. *Klein* (*supra*), a case in which our dear friend Archie H. Cohen represented the debtor John Horne Co. The case originated in the District Court for the Northern District of Illinois in December 1951. After a Section 321 Chapter XI proceeding with the debtor in possession had miscarried, the debtor was adjudicated in October 1952. The government filed claims for federal unemployment and

withholding taxes for the calendar year ending December 31, 1951 and asked their allowance as an administrative expense. The trustee conceded the government's entitlement to priority under Section 64(a)(4), but denied the government's claim to priority under 64(a)(1). With respect to wages earned and paid subsequent to bankruptcy (when the debtor was in possession under Chapter XI) the trustee conceded a 64(a)(1) priority. Both Referee Wallace Streeter and the District Court supported the trustee's position. On appeal the Circuit Court affirmed, assigning to the government a fourth priority on its claim. The distinguishing characteristic between the Klein and the Fogarty cases lies in their facts. In the Klein case pre-bankruptcy wages had been both earned and paid before bankruptcy so that the government's claim was for "taxes legally due and owing by the bankrupt to the United States" and was entitled only to a fourth priority under 64(a)(4). In the Fogarty case pre-bankruptcy wages had been earned but had not been paid at the time of bankruptcy, with the result that the Court held there was no tax due and owing to the government at that time. Thereafter when claims for such wages were allowed and paid in the bankruptcy proceedings, they were subject to applicable laws and withholding which the Court then assigned a first priority.

But after distinguishing the Klein and Fogarty situations the Court was moved to observe that it was not impressed with the reasoning of the Fogarty case and went on to say: "the government would have the Court embrace what the government characterizes as 'the overall policy of the taxing statute.' Its contention, if accepted, might not do any violence to the taxing statute, but it would make a shambles of the Bankruptcy Act". It is at least doubtful whether the 7th Circuit will follow the Fogarty case when the matter comes up again on comparable facts.

In *Pomper* v. *U. S.* (CCA 2nd 1952) 196 F(2d) 211, the debtor filed a Chapter XI Proceeding on November 14,

1947 and was continued as a debtor in possession through September 1948. The debtor's Federal Unemployment taxes for the year 1947 became due January 31, 1948. The government claimed the entire unemployment tax for 1947 as an administrative expense entitled to first priority in payment. The Referee allowed the claim as a fourth priority only as to wages earned prior to November 14, 1947 when the bankruptcy proceeding was instituted and granted leave to the government to file an amended claim for that portion of the annual payroll tax due on wages paid out after November 14, 1947 when the debtor was in possession as a claim entitled to a first priority.

On appeal the 2nd Circuit affirmed. There was a dissent by Judge Clark objecting to the apportionment. He viewed the taxing statute (I.R.S. Sec. 1600-1611) as assessing a single unit tax on the employer for each calendar year of 3% on total wages paid by him during the calendar year.

In March 1957 the rolling ball to which I referred earlier took a peculiar turn of direction. The 9th Circuit in *Matter of Blackwood* (*supra*) applied the decision of *U. S.* v. *Fogarty* to a claim by the State of California for state unemployment taxes. The impact of this decision is that the rule of the Fogarty case is expanding.

Briefly stated, the trustee after paying allowed expenses of administration, paid the balance of moneys in his hands to priority wage claimants on a percentage pro-rata dividend. In doing so he deducted state and federal taxes assessed against the employees. The State of California having filed a claim for state unemployment taxes which are assessed against the employer, claimed the right to payment out of such wage dividends as well. The District Court supported the claim in California using *U. S.* v. *Fogarty* and *U. S.* v. *Curtis* as authority. On appeal the 9th Circuit affirmed. In doing so it went beyond the cases of Fogarty and Curtis by pointing out that under the California Code "wages" are defined as "all remuneration

payable for personal services, whether by private agreement or consent or by force of statute"; so that when a dividend on wage claims is paid out, it is done "by force of statute". Concluding with the proposition that sums paid as wage claim dividends are "wage" payments within the meaning of the California Code, and are subject to deduction for state unemployment taxes. Moreover, when deducted, such taxes are payable as a first priority expense under Section 64 of the Bankruptcy Act!

That is where the cases stand today. There will be more. My own Circuit, the 3rd, hasn't been asked to pass upon this question; neither has the 2nd Circuit so far as I know. But the same question is being encountered in every Circuit at the Bankruptcy Court level. The situation is one of nuisance to put it bluntly. Seldom is there any substantial tax sum involved. In the Fogarty case the sum involved was $1,491.34; in the Blackwood case it was $28.38. In the other cases the amount is undisclosed. It is safe to assume, however, that the amount of tax money collected from Bankrupt estates under the rule of the Fogarty case is small indeed. It is not worth all the trouble and expense it entails for Bankrupt estates.

Receivers and Trustees are usually persons who have no training in payroll accounting details. They usually need help in such matters and accounting services are expensive. Such expense as is entailed is borne by creditors in lower classifications, usually the lowly general creditors, whose burdens and fortunes are poor enough. In the end the result is difficult to justify. In some instances the payment is even circuitous by reason of tax refunds.

The Fogarty case is bad law. It is bad not only in its logical foundations but also in its practical applications. It produces a distortion in the bankruptcy function of distribution. In its practical effects it makes the Bankruptcy Court a virtual adjunct of the Bureau of Internal Revenue. In every sense of the word the Fogarty case

makes the Court a collector of taxes not only for the United States but for the States as well when the tax is one assessed on payroll. All of these factors suggest its faulty character.

It is fairly certain that Congress never considered or remotely intended that Courts of Bankruptcy should have withholding obligations on wage claim distributions; or that such distributions would be considered "wages"; or that the trustee in a bankruptcy liquidation was an "employer"—in any sense of that term.

The greatest iniquity which the rule of the Fogarty case accomplishes is that of allowing the government with a payroll tax claim to escalate and boot-strap its way from a fourth to a first priority under this doctrine. The overall effect is to partially nullify Section 64(a) of the Bankruptcy Act. This is its chief evil.

As far back as October 1951 our brother Referee Samuel C. Duberstein of New York in submitting the report of this Associations Committee on Improvements of the Bankruptcy Law, recommended the need for legislation to remove the burden of making and paying withholding and social security deductions on dividends paid on claims filed for pre-bankruptcy wages which the Fogarty and Curtis cases then imposed. I plead for action again, because it produces disorder in our scheme of distribution.

Orderliness is a great virtue. It is applicable to things in nature as well as to ideas. It is an essential quality in any system of thought. It is also a quality to be achieved in a system of jurisprudence. Orderliness implies harmony and things and ideas that are in harmonious relation are pleasant to look upon; those which are not have a quality of dissonance and we tend to shun and avoid them. The Fogarty case strikes a discordant note in our field of the law, it is out of harmony with sound bankruptcy law. Let us rid ourselves of it!

Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 728

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

On the following papers:

> Notice of Motion, dated November 5, 1969, and supporting Application of William Otte, Trustee in Bankruptcy of Freedomland, Inc., by his attorney, Martin J. Caine, dated November 5, 1969, with proof of service upon Respondents; Answer of Respondent, United States, dated March 11, 1970, Answer of Respondent, City of New York, dated November 14, 1969,

and Respondent State of New York having been served with a copy of the Trustee's Notice of Motion and supporting Application but having defaulted in appearing and pleading to the Trustee's application, and the matter having come on to be heard on September 8, 1970, and after hearing the Trustee, William Otte, by his attorney, Martin J. Caine, by Howard Karasik, of counsel, in favor of the application, and Respondents United States and City of New York, by their respective attorneys, Honorable Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, by Susan Freiman, of

counsel, and Honorable J. Lee Rankin, Corporation Counsel, City of New York, by Raymond Herzog, of counsel, in opposition, and after filing the decision herein dated January 27, 1971, it is, on motion of Martin J. Caine, attorney for the Trustee

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., is authorized and directed upon the declaration of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims in this proceeding, to distribute to such claimants the full amount of their respective claims as filed and allowed, without withholding or deduction of United States, New York State, or New York City income, payroll, social security or other taxes of any nature, type or description, and it is further

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., is *not* required under law:

a. to withhold or deduct from any distribution of a dividend to class (2) priority wage claimants and/or to non-priority wage claimants in this proceeding any income, withholding, social security, or any other payroll taxes claimed by the United States, the State of New York, or the City of New York;

b. to pay to the United States, the State of New York, or the City of New York, any amounts whatever in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims in this proceeding, other than such amounts as are set forth in a class (1) administration expense claim or a class (4) priority tax claim filed and allowed in this proceeding;

c. to file any report or tax return with the taxing authorities of the United States, the State of New York, or the City of New York, in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims.

d. to prepare or distribute to class (2) priority wage claimants and/or to non-priority wage claimants, or to file with the taxing authorities of the United States, the State of New York, or the City of New York, wage and tax statements (forms W-2) in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims;

and it is further,

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., and individually, shall have no liability whatsoever to the United States, the State of New York, or the City of New York, by reason of any alleged failure to perform any of the functions set forth in subparagraphs (a), (b), (c) and (d) of the second decretal paragraph of this order, or by reason of his compliance with the terms of this order.

New York, New York
February 26, 1971

/s/ EDWARD J. RYAN
Referee in Bankruptcy

Affidavit of Service

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

State of New York
County of New York ss.:

LINDA LABATO, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 110 Rellim Drive, Old Bridge, New Jersey. That on the 2nd day of March, 1971, deponent served the within Order upon the following:

HONORABLE WHITNEY NORTH SEYMOUR, JR.
United States Attorney for the
Southern District of New York
U.S. Courthouse
Foley Square
New York, New York
Att: Miss Susan Freiman
Assistant U.S. Attorney

Affidavit of Service

HONORABLE J. LEE RANKIN
Corporation Counsel of the
City of New York
Municipal Building
New York, New York
Att: Robert Herzog, Esq.
Assistant Corporation Counsel

HONORABLE LOUIS J. LEFKOWITZ
Attorney General of the
State of New York
80 Centre Street
New York, New York

by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in an official depository under the exclusive care and custody of the U.S. Post Office Department within the State of New York.

LINDA LABATO

Sworn to before me
March , 1971

Transcript of Testimony, Dated January 20, 1972

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Before: HON. CONSTANCE BAKER MOTLEY,
District Judge.

New York, N. Y.,
January 20, 1972.

APPEARANCES:

WHITNEY NORTH SEYMOUR, JR., Esq.,
United States Attorney,
For the Government;

SUSAN FREIMAN, Esq.,
Assistant United States
Attorney, of counsel.

J. LEE RANKIN, Esq.,
Corporation Counsel, City of New York;
RAYMOND HERZOG, Esq.,
Assistant Corporation Counsel, of counsel.

WILLIAM OTTE, Esq., Trustee;
HOWARD KARASIK, Esq.,
Attorney for Trustee.

DAVID SHANDALOW, Esq.,
Attorney for Bankruptcy Lawyers Bar
Association, amicus curiae.

* * * * *

Robert A. Wiener—for Trustee—Direct

(86) • • •

ROBERT A. WIENER, called as a witness by the Trustee, being first duly sworn, testified as follows:

Direct Examination by Mr. Karasik:

Q. Mr. Wiener, are you an accountant? A. I am.

Q. Are you a certified public accountant? A. I am.

Q. Were you retained pursuant to court order by the trustee in bankruptcy? A. I was.

Q. Is there any area of specialization in accountancy that you specialize in? A. I have specialized in insolvency accounting since 1949.

Q. Do you know where the bankrupt's records are located? A. At Underwriters' Salvage.

(87)

Mr. Karasik: Your Honor, the trustee's report filed in this proceeding indicates that there are forty-two filing cabinets filled with records. I ask the Court to take judicial notice of the fact that such is the trustee's report.

The Court: Wait a minute. The trustee——

Mr. Karasik: Has filed a report. It is incumbent upon the trustee in a bankruptcy proceeding pursuant to the rules of the court to file a report with the court advising the court of the records that the trustee has taken into his possession.

There is on file the trustee's report indicating that there are forty-two filing cabinets filled with records of the bankrupt located at Underwriters' Salvage Company. This has a bearing, your Honor—

The Court: What do those records relate to?

Mr. Karasik: Well, these records relate to all of the business activities of the bankrupt.

Miss Freiman: Your Honor, may I interpose an objection. Even if the trustee's report were properly

received the existence of forty-two filing cabinets filled with records of the bankrupt, I do not feel has any relevance to the question before the Court today.

The Court: Yes, I don't see the relevancy of it.

(88)

Mr. Karasik: The relevancy is—it goes to the question of the burden and the ability of the accountant to ascertain the exact amount of taxes that would have to be deducted in the event the Government were to prevail in its position.

It also goes to the problem of ascertaining the social security numbers of the various employees who have filed claims in this proceeding, assuming, of course, that the Government were to prevail.

Miss Freiman: Your Honor, I fail to see how the bankrupt's records would have anything to do with the tax due on a $600 payment made years after the bankrupt has gone out of business.

Mr. Karasik: The records relate, among other things, to ascertaining social security numbers, which, as will be shown, are very important to the recipients of wage claim payments.

The Court: Well, are you suggesting that the fact there are forty-two filing cabinets in the last five or six years that this matter has been pending that the trustee has not gone through those records to see what is contained therein?

Mr. Karasik: The trustee—when it becomes necessary for particular purposes the trustee will go through (89) certain records. It is in terms of the economy of the administration of the bankruptcy proceeding that the trustee avoids going through the records because it is unnecessary.

Now, in this particular case there may never be a distribution to general unsecured creditors, and therefore it is unnecessary at this point to go through

the bankrupt's books and records to evaluate the propriety or correctness of claims by the unsecured creditors. But if the trustee or his accountant has to go back to look through records to ascertain, among other things, social security numbers or exemptions or things of that nature, then of course it would become extremely burdensome to come up with a correct record of monies that would have to be paid out to individual wage claimants.

Mr. Herzog: Well, your Honor, I'm going to object to this.

The Court: Yes. That assumes that the forty-two filing cabinets are just a hodge-podge and nobody knows anything about them. That would have to be your basic assumption, that here we have forty-two files which have never been properly filed and entirely mixed up and confused so that nobody can work with those files.

Mr. Karasik: I am not prepared to offer testimony as to that, even though this is my belief.

(90)

By Mr. Karasik:

Q. Let's go to the heart of the matter, Mr. Wiener. What steps would you have to take to ascertain the exact amount of the United States, New York State and New York City taxes that would have to be withheld in connection with a wage claim distribution to employees or former employees of the bankrupt if the Court determines that such withholding should be made? A. I would have to determine the social security number of each wage earner. I would try to determine the possible exemptions by direct communication with each wage earner based on the address shown on the claim.

I would then, after determining the exemptions, deter-

mine the amount of taxes that should be deducted on the wage payment for Federal, State and City.

I would have to prepare a detailed schedule for reconciliation purpose showing the name, the social security number, the total wage claim as allowed, the amount of Federal tax withheld, the amount of social security tax withheld, the amount of New York State tax withheld, the amount of New York City tax withheld.

I would have to summarize that and cross-reference it. The information, after being summarized, cross-referenced and cross-footed, would be transposed initially to the (91) Form 941.

The Court: What do you mean by cross-referenced?

The Witness: Back to the claim filed in the proceeding, and make sure of the accuracy of the schedule.

The Court: All right, go ahead.

A. (Continuing) the information contained in this schedule would then be transposed to the Form 941, with the social security number, the name, the amount of the wage. A computation would then be made at the top of the 941 determining the amount of social security taxes, and then the balance inserted for withholding taxes.

Then the W-2 forms would have to be prepared, in which would be inserted the name of the employer, care of the trustee in bankruptcy at the trustee's address, with the identification number as indicated by the previous witness. And all of the items indicating the Federal income tax withheld, the wages paid subject to withholding, the social security withheld, the total social security wages, the information as to whether the taxpayer was single or married as obtained by communicating with the taxpayer, the name of the state, the city, the state form number, the city form

number, the state income tax withheld, and the city income tax withheld.

After all of these forms were typed or written out, (92) an adding machine tape would have to be taken of all of the withholding tax set forth in the various categories, as well as the social security taxes, and that would then have to be compared with both the schedule previously referred to and also the Form 941.

Thereafter the various forms would have to be separated. The annual reconciliation forms would have to be secured from the various taxing agencies. The taxing agency forms which were required for each agency would be separated and forwarded to the taxing agency, together with the remittance and the reconciliation form, and then the form to the employees would be forwarded to them, and the retained copies kept for the trustee's file.

Checks, of course, would have to be made out to each employee.

Q. That is with regard to priority wage claims. Suppose there was a sufficient amount of money in the estate to also make payments for non-priority wage claims, would the same procedure have to be followed again? A. A separate list would have to be prepared, computing a dividend as to the amount of the allowable non-priority wage claims, a separate computation made, and then the two schedules would then have to be combined in order to prepare, on a third schedule, in order to prepare both the W-2 forms (93) and the Form 941.

Q. If a man earned $150 a week and had two exemptions would a flat deduction of 25% for Federal withholding tax purposes be more than the amount that would be withheld if the ordinary tax schedules were used? A. Yes, sir.

Miss Freiman: Objection. Your Honor, the Internal Revenue tables speak for themselves, and in a[illegible] event, I do not believe that Mr. Wiener is in a

position where he can speak for the Internal Revenue Service as to what the correct amount of withholding is.

Mr. Karasik: Mr. Wiener is an accountant.

The Court: He is asking him to assume that 25% is withheld and asking him whether that would be more than——

Mr. Karasik: If a man earned $150 per week and had two exemptions——

The Court: Yes, I understand.

Mr. Karasik: —whether a 25% deduction——

The Court: Overruled.

A. The deduction for withholding tax under those circumstances, Federal withholding tax, would be $21.40, and then there would be a deduction of between seven and eight dollars—that's 5.2% of $150—that would be a total of twenty-seven or twenty-eight dollars, as compared to 25% of (94) the $150 which would be $37.50, a difference of a little less than $10.

Q. If a priority wage claim were made without deductions to a wage claimant in a bankruptcy proceeding, and on the assumption that the taxable income for that recipient was the same, would the recipient have to report the receipt of payment on his income tax return? A. Yes.

Q. And would he have to pay the tax to the United States Government? A. Yes.

Q. Now, if the trustee were required to withhold taxes in making a priority wage claim distribution, would the trustee be subject to inquiries from the recipients of the wage claimants as to why the deductions were made? In your experience, has this been done? A. It happens frequently.

Q. And the accountant also? A. The accountant always gets the inquiry.

Robert A. Wiener—for Trustee—Direct

Q. If a wage claim payment was made to an individual and a W-2 form prepared without a social security number indicated on the W-2 form, would the recipient of the wage claim payment be credited with the appropriate social security deduction withheld by the employer?
(95)

Miss Freiman: Objection, your Honor. I do not believe Mr. Wiener can testify to what the Social Security Administration would do.

A. With all due respect, the question is improperly phrased anyway. The credit is not from the W-2 forms, it's from the 941's.

Q. All right, then from the 941, if there is no social security number indicated on the form 941, would the recipient of a wage claim distribution be given credit for social security purposes?

Miss Freiman: Your Honor, again I object. Mr. Wiener is being asked to speculate—

Mr. Karasik: He is not being asked to speculate; the man is a Certified Public Accountant and I am asking him to testify from his experience as an accountant as to what the law is.

Miss Freiman: He is asking, your Honor, that Mr. Wiener tell us what he thinks Social Security would do.

The Court: Isn't that what you are asking him?

Mr. Karasik: I am not asking him—

Q. I'd like to know, Mr. Wiener, what does, in fact, Social Security do?

The Court: How does he know that? What is that based on?

(96)

The Witness: I can tell you, your Honor. If a 941 is filed without a social security number, marked unknown, shortly thereafter the filor, in this case the trustee in bankruptcy, receives a little card, an IBM card, from the Social Security Administration, advising the trustee, and this would apply to any employer, that since the number is unknown credit cannot be given and asking that the trustee or any other employer can furnish such number, and usually they send at least two requests.

Q. And again I ask the question: are you familiar with the Social Security procedure as to whether or not an individual receives credit where social security payments have been withheld but on this 941 no social security number is indicated? A. I am.

Q. And what is the practice? A. The individual does not get credit.

Q. If an individual wage claimant was receiving distribution of a wage claim, and if that wage claim were considered wages, and if that individual was receiving unemployment insurance coverage, what effect would the receipt of the wage claim distribution have on the individual's unemployment insurance coverage? A. It would terminate his unemployment insurance.

(97)

Q. If an individual is 65 years of age and is receiving social security benefits, what is the maximum amount of money he can receive and still be eligible for social security?

Miss Freiman: Your Honor, I believe I stated at the outset the Government's position that all of this is irrelevant, and I would appreciate being given a continuing objection to what might happen in

individual cases rather than interrupt repeatedly as Mr. Karasik is questioning.

The Court: Well, with respect to Mr. Karasik's claim that the Court ought to, in effect, disagree with the Sixth Circuit in Fogarty and find that this is not a wage payment, I suppose it may be relevant to that, as a matter of policy concerning a wage claim. So I will let him answer the question.

Miss Freiman: Your Honor, for the record, may I also state that my objection is also on the ground that I believe that Mr. Karasik may be offering it to show that the 25% which has been administratively fixed is arbitrary and capricious and unreasonable, and I also object to the introduction of the evidence on that ground.

Mr. Karasik: I hadn't thought of it but it is a good reason for introducing it.

The Court: All right, proceed.

(98)

A. What is the question?

(Record read.)

A. It used to be $1,200 and I believe they have increased it to either fourteen or fifteen hundred. I'm really not sure of the exact amount.

Q. Of earned income? A. That's right.

Q. Now, if a wage claim distribution were considered wages, and the wage claim recipient actually received that money, what effect would the receipt of that money have on the individual who had earned the maximum amount of money during the course of the year and who was also eligible for social security benefits? A. It would affect the amount of the benefits; it would reduce his benefits.

Cross-examination by Miss Freiman:

Q. Mr. Wiener, you gave us a long, and if I may compliment you, eloquent description of what would be done to prepare the W-2 forms and the 941's. Are you also familiar with the functions performed by a trustee's accountant in checking proofs of claim? A. Yes, I am.
(99)

Q. Would you please tell us what you have to do in order to check a proof of claim? A. In sum, to make comparisons between the proofs of claim and the books and records of the bankrupt.

Q. What more has to be done in order to either withhold and to prepare the return? A. We're not talking about the same taxes, are we, Miss Freiman?

Q. Well, if I may explain a little bit: When a trustee is obligated to check proofs of claim, is it customarily done by the trustee or by his accountant? A. By his accountant.

Q. Well, when you check the proofs of claim, you make certain comparisons to determine whether the claim is correct or not correct; is that right? A. Yes, that is right.

Q. And you described to us what you do when you withhold upon making a distribution to the wage claimant. A. Yes.

Q. How much more work is imposed on you by the requirement to withhold and to pay the Government? A. You're talking about two different things, Miss Freiman.

The Court: Well, tell us first what you do with (100) respect to an ordinary claim from a creditor; what do you do in checking that claim?

The Witness: Initially, we compare the claims to the schedules filed in the bankruptcy proceeding. If the claim agrees with the schedules filed in the bankruptcy proceeding, we recommend its acceptance. If it does not agree, then we go back to the bank-

rupt's books and records and make a comparison to the statement which is frequently attached to the claim and try to prepare a reconciliation. If we find that the variance is substantial and that there are sufficient assets in the case to make it important to object to the claim, we recommend to the trustee that he bring on objections and formal hearings before the referee in bankruptcy.

The Court: In this case were the wage claims scheduled?

The Witness: The wage claims would also be checked back to the books and records of the bankrupt.

The Court: My question was, in this case, were these wage claims scheduled?

The Witness: I would have to make a comparison. I believe that they were scheduled—I haven't looked at the schedules recently, but my recollection is that they were scheduled.

The Court: Well, what do we have to do to find (101) out whether they were or weren't?

The Witness: Mr. Karasik has some schedules in court, I believe.

Mr. Karasik: I have some scehdules here, your Honor.

The Witness: May I see the schedules you have with you? I believe there is an indication on those schedules as to whether or not they were scheduled.

(Document is handed to the witness.)

The Witness: Yes, I believe that they were scheduled, your Honor.

The Court: Are you looking at a document which shows that they were scheduled?

The Witness: The document states, "Amount due as per bankrupt's books," and I am reasonably certain that indicates they were scheduled.

The Court: All right.

Mr. Karasik: Your Honor, the schedules are a matter of public record in this court.

The Court: I don't have the so-called public records before me.

Mr. Karasik: This hasn't been an issue, otherwise I would have brought out a complete set of schedules, had I known.

(102)

The Court: Well, we could always find out, if we can, but I think it is important to know in this case whether these wage claims were scheduled.

By Miss Freiman:

Q. Mr. Wiener, do you yourself prepare W-2 forms for trustees? A. No, ma'am.

Q. Who in your office does prepare them? A. One of the junior accountants.

Q. What is there about his training which is required for him to prepare these returns? A. Familiarity with payroll records, and the Internal Revenue Code and regulations.

Q. Why does he need to know the code and regulations? A. For the proper preparation of these forms.

Q. Now, if the Internal Revenue Service just requires a flat 25% withhled of which 5.2% is for FICA and the balance is for income tax, is his training required for that? A. No.

Q. Mr. Wiener, who determines how much gets paid to general creditors in the event the estate is large enough? A. The trustee or his counsel makes that calculation, and on occasion we do the calculation depending on the size of the estate.

(103)

Q. If there is an estate of $5,000 and they only spend $900 from five, and the amounts of the claims vary from

$30 to $100,000, how is it determined how much paid to each particular creditor? A. By a mathematical computation made after the referee in bankruptcy has determined the expenses of administration, the remaining assets for payment of priorities under the Bankruptcy Act, and then the portion of the money remaining to unsecured creditors.

Q. Could you explain to us the manner in which this mathematical computation is done, the formula which is followed? A. In the first instance, there would be a determination of the gross amount of the estate, the amount of cash remaining on hand in the possession of the trustee. Then an examination would be made of the referee's report of allowances and the expense of administration.

We would then deduct the amount from the assets in the estate, and assuming your $5,000 in the estate, less, let's say, $1,000, and there was $500,000 in claims, you would make a mathematical computation, theoretically spreading the $1,000 over the $5,000 by using a calculator or some other adding machine.

Q. In other words, you would have to add up the total (104) amount of all of the claims and then for a $30 claim, the particular creditor would get thirty over the $500,000 in claims? A. Theoretically, yes.

Q. Have you ever heard of a trustee requesting the bankruptcy court for leave not to make those payments because the computations are difficult? A. I don't know; I don't remember.

Q. Do you have a copy of the social security IBM card with you? A. No, I do not.

Miss Freiman: You Honor, I move to strike all of the testimony about that IBM card because I have not had an opportunity to study it and cross-examine on it.

Mr. Karasik: Your Honor—

The Court: Just a moment. What social security IBM card is that?

Miss Freiman: Mr. Wiener has testified that social security never gives credit when there is no social security number given for an employee, and he based on an IBM card that he talked about. He does not have the IBM card here, and I therefore do not have an opportunity to examine it and cross-examine about it.

The Court: He based that on an IBM card?

(105)

Mr. Karasik: He based it on his knowledge as an accountant with expertise in insolvency matters, and no IBM card was introduced in evidence.

The Court: Well, the problem can be resolved by calling somebody from the Social Security Administration.

Miss Freiman: Well, your Honor. I would like to call Miss Pillinger again. She is familiar with that aspect of the problem.

The Court: Wait a minute. I said somebody from the Social Security Administration. We have an office here in New York, don't we? Can't we resolve this question by calling somebody from there?

Miss Freiman: I could try, your Honor, if we could continue this case until tomorrow, but I believe that Miss Pillinger is familiar enough with this so that she could testify to what happens when a social security number is not given.

The Court: She did it before when she was on the stand, didn't she?

Miss Freiman: In any event, I do press my objection to Mr. Wiener's testimony about the social security because it does not give particulars.

The Court: Well, I think the way to resolve it is to call somebody from the Social Security Adminis-

tration (106) and tell us what does happen when a number is not furnished. It would be very simple for somebody to walk over here from the Social Security office. So we will take that tomorrow.

Is there anything more that you have of this witness?

Miss Freiman: No, your Honor.

The Witness: Thank you very much, your Honor, for permitting me to testify today.

The Court: I think in this connection the trustee's counsel should get out from the records a copy of the scheduling of these claims, so that we could clarify that point, as to whether or not they were scheduled also.

Mr. Karasik: As the Court is aware, the fact that something is scheduled does not mean that the trustee in bankruptcy is bound by what is scheduled. As a matter of practice, it frequently occurs that accountants for trustees will go behind the scheduled amounts, to the books and records, and the trustee is not bound by what is scheduled, because if he were——

The Court: That may very well be, but I want to know what the facts are in this case. This is the way the matter was conducted before the referee, nobody really pinned down any particular facts. Isn't that the problem we have here? There were a lot of things suggested, but nobody really said what the facts were.

Mr. Karasik: I could arrange to have——

The Court: You say this was burdensome, and that was based on no evidence. That's what I am trying to get at. You also said there was a rule here, a 25% rule, which nobody attempted to explain the origin of, and that is why we have to have a further hearing here.

What we ought to do now is to try to complete the record here with respect to the facts. If these things were scheduled, they were scheduled. If they were not scheduled, they were not scheduled. We are only asking to know whether they were in fact or not. We don't need any argument as to what is liable to happen at some time to the scheduling. All we want are the facts.

I want to know whether they were scheduled, and how much each employee claimed, in any event, and copies of the proofs of claim; that is, what was sent in by the employees. We can then see whether any of those claims contain a social security number.

What we will do then is to recess until noon tomorrow so that you can have a chance to get those records out.

Mr. Karasik: Thank you.

(Adjourned to January 21, 1972 at 12:00 noon.)

Opinion On Petition To Review

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

APPEARANCES:

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Opinion On Petition To Review

CONSTANCE BAKER MOTLEY, *D.J.*

Freedomland, Inc. filed a petition for an arrangement under Chapter 11 of the Bankruptcy Act on September 15, 1964. The arrangement proceeding failed and on August 30, 1965 the debtor was adjudicated a bankrupt. Thereafter, on November 7, 1969 the trustee, William Otte, moved before the referee for an order authorizing him to pay 413 priority wage claimants without withholding therefrom United States, New York State, or New York City income taxes, federal social security taxes, or any other payroll taxes. This relief was granted.

The Bankruptcy Act, Section 64(a), 11 U.S.C. § 104, establishes five categories of claims, in descending order, which are entitled to payment before the general creditors of the bankrupt are paid. The payment of claims for wages earned within the three month period preceding bankruptcy, in amounts not exceeding $600, falls within the second category of priorities. Claims for taxes which "became legally due and owing" by the bankrupt to any governmental body are entitled to a fourth priority.

The trustee was also granted an order specifically declaring that he was not required to: 1) pay to any governmental body any amounts whatsoever in connection with such wage claim distributions; 2) prepare and distribute to the wage claimants employee wage and tax statements and file copies thereof with tax authorities; 3) prepare and file with tax authorities employer wage and tax withholding statements; 4) pay any penalties for failure to withhold and pay or file returns.

The United States, the State of New York, and the City of New York had been given notice of the trustee's application for such a declaration and order, although none had filed a proof of claim for income taxes due on these

wages.[1] The 413 wage claimants had filed their proofs of claim within the six month period following the initiation of bankruptcy proceedings on September 15, 1964 as provided by the Bankruptcy Act. 11 U.S.C. § 93. The total of these wages ($80,000) had been scheduled by the bankrupt upon the filing of his September 14, 1965 petition for an arrangement.

The State of New York failed to respond. The City of New York responded claiming that the trustee is required to withhold from any wage claims paid by him New York City income taxes and to report and pay same to the City, although the New York City income tax law was not in existence in 1964—the time when the wages were earned by the employees. The United States responded claiming that the trustee is liable to: 1) withhold income and social security taxes;[2] 2) pay such taxes to the United States;[3] 3) file the necessary returns (forms W-2 and 941);[4] 4) furnish each employee with form W-2;[5] and 5) pay any penalty assessed for failure to withhold, pay and file the returns.[6]

Succinctly stated, the trustee's position in support of his application was as follows:

1) Since 413 priority wage claims have been filed in this proceeding, none of which exceeds $600.00, compliance

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[1] The United States had filed a claim, Claim No. 441, on February 9, 1965 seeking payment of $82,565.14 for federal income and social security taxes due on those wages actually paid during the third quarter of 1964. The 413 claims here relate to the unpaid wages during this period. This was the quarter immediately preceding any bankruptcy proceeding. The City of New York had filed claims for other city taxes such as amusement taxes.

[2] 26 U.S.C. §§ 3402(a), 3102(a).

[3] 26 U.S.C. §§ 3402(d), 3102(b), 3403, 6672, 7201.

[4] 26 U.S.C. §§ 6011(a), 6041(a), 7203.

[5] 26 U.S.C. §§ 6051(a), 7204.

[6] 26 U.S.C. § 6674.

with federal, state and city tax provisions would be onerous because of the administrative, accounting, and legal costs involved, and the unavailability of relevant information. Public policy, administrative convenience, the scheme of the Bankruptcy Act, and the policy underpinning withholding taxes dictate that the trustee in bankruptcy not be required to withhold taxes and file returns in connection with payments to wage claimants.

2) Making an automatic 25% federal tax deduction (which is the present practice in this District) and a 1% city deduction, in lieu of making an exact calculation of the taxes due from each employee pursuant to progressive tax tables and currently claimed exemptions would constitute a substantial tax over-payment for each employee and therefore would be unconstitutional.

3) A class 2 priority wage claim payment made pursuant to the Bankruptcy Act, § 64a(2), does not constitute wages for the purposes of the withholding and reporting provisions of the Internal Revenue Code;

4) New York City is not entitled to have income taxes for its benefit withheld since, if the wages had actually been paid when due, nothing would have been due the city.

In response to the trustee's claims the United States took the following positions:

1) The bankruptcy court is without power to consider the trustee's application on the ground that a declaratory judgment and injunction with respect to taxes is specifically prohibited. The trustee's remedy is to pay the tax for 1 wage claimant and sue for a refund. Under the doctrine of primary jurisdiction the bankruptcy court should at least refrain from acting until the Internal Revenue Service, the administrative agency to which has been given the authority to interpret and apply the statute, has acted.

2) Assuming the court does have jurisdiction, the Internal Revenue Code requires the trustee to withhold, report and pay income and social security taxes.

3) The 25% flat rate rule prevailing in this District is reasonable in view of the fact that, as the trustee argues, it may often be difficult to determine the correct rate for each employee.

From the adverse decision and order of the referee, the United States and the City of New York filed the instant petition for review.

The referee ruled that the bankruptcy court had jurisdiction of the application made by the trustee for instructions with respect to the proposed distribution to wage claimants, and that the Government's contention with regard to lack of jurisdiction was without merit. This court agrees. The bankruptcy court clearly had jurisdiction to adjudicate the tax claims now made by petitioners in response to the trustee's application for an order. The United States and the City both claim that the taxes in issue are costs and expenses of administration and are therefore entitled to a first priority under § 64(a) of the Bankruptcy Act. 11 U.S.C. § 11 (2) and (2A). See *United States* v. *Randal,* 401 U.S. 513 (1971) and *Nicholas* v. *United States,* 384 U.S. 678 (1966), and cases cited *infra* where the bankruptcy court's jurisdiction over similar claims was apparently unchallenged.

The gist of the controversy, as the referee saw it, is whether a trustee in bankruptcy is an "employer" who is paying "wages" when he makes a distribution to wage claimants who are entitled to priority in distribution of estate assets by virtue of the Bankruptcy Act, so that as such "employer" the trustee is required to comply with the applicable withholding and reporting provisions of federal, state, and city tax laws.

The referee reviewed this question as requiring a decision with respect to "which of two clearly desirable, but countervailing objectives is to be preferred, viz., the collection of taxes or the efficient administration of the estate in bankruptcy." [7] Viewing the issue in this fashion, the referee preferred the Bankruptcy Act on the ground that "compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and letter of the Bankruptcy Act." [8] He found that compliance with taxing requirements imposes a further burden on the administration of bankrupt estates which is entirely inconsistent with the objective of efficient, expeditious, economic administration of bankrupt estates.[9] He accordingly held "that a trustee in bankruptcy is not an employer who pays wages when he distributes dividends on account of wage claims whether priority or general." [10]

In so holding, the referee expressly rejected the holding to the contrary in the twenty-five year old precedent, *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), followed in *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. den.,* 339 U.S. 965 (1950); *In re Daigle,* 111 F. Supp. 109 (D.C. Me. 1953); *Lines* v. *State of California,* 242 F.2d 201 (9th Cir. 1957), *cert. den.,* 355 U.S. 857; *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir. 1964). In the *Fogarty* case the Eighth Circuit ruled that the payment of wage claims are "wages" within the meaning of applicable federal tax provisions and that the trustee as the person in "control of the payment" of such wages has the duty under the Internal Revenue Code to withhold and pay income and social security taxes thereon. And it appears that no court has yet ruled contrary to the *Fogarty* court

[7] Referees' Opinion, pp. 7-8.
[8] *Id.* p. 12.
[9] *Id.* p. 10.
[10] *Id.* p. 12.

on the issue of the duty and liability of the trustee to withhold and pay such taxes. The *Fogarty* court viewed the need to protect the future social security benefits of wage earners, which are based solely on wages earned, as of paramount importance in the distribution of wage claims. The able referee, correctly, was of the view that, since this precise question of the liability of a trustee in bankruptcy to withhold and pay has not been passed upon by the Court of Appeals for this Circuit (or the United States Supreme Court), he was free to hold to the contrary.

In rejecting the ruling in the *Fogarty* case, the referee concluded that the "basic vice of *Fogarty* was its consideration of the problem before it merely as a tax case without giving due regard to the consequences to orderly, efficient, economic bankruptcy administration which necessarily ensue from that ruling."[11] In deciding not to follow the Eighth Circuit, the referee relied completely on the criticism of the *Fogarty* case made by another referee, Russell L. Hiller of Pennsylvania, in a paper entitled "The Folly of the *Fogarty* case". The critique is attached to the referee's opinion. The Hiller paper was read at the Annual Conference of the National Association of Referees in Bankruptcy in Indianapolis in October 1956, about a decade after *Fogarty*. Referee Hiller stated at the time: "In practice, as any referee knows, the application of the *Fogarty* rule is sheer nonsense." Referee Ryan agreed. However, other than the one example given by Referee Hiller in his paper, there was no evidence in the record before Referee Ryan to support his conclusion.

Referee Hiller had cited a case before him in which it cost an estate $600 to have the bankrupt's former comptroller, who was familiar with the payroll, calculate the taxes and prepare a schedule of net payments due each wage claimant. In that case the gross payment to the

[11] *Id.* p. 10.

United States for withholding taxes was $1,611.41 and $1,761.72 for employment taxes. Since the amount of taxes due in that case was small compared to the cost, Referee Hiller concluded the *cost* of compliance with tax provisions to a bankrupt estate is unjustified. Despite the *Fogarty* decision and Referee Hiller's criticism, however, the Congress has not seen fit to relieve the trustee of whatever burden (whether financial or otherwise) compliance with tax provisions may impose on bankrupt estates.

This court, uncertain as to what burdens are in fact imposed, received further evidence with respect to the administrative burden and costs which would be imposed upon the trustee here in meeting federal and city taxing requirements.[12] The court felt that such further evidence was necessary not only in view of the fact that there was no evidence before Referee Ryan (other than the Hiller example) to support the referee's conclusion but apparently little in his experience also as a referee in this District to sustain the conclusion. Referee Ryan in his opinion said:

> "In practice, except in rare cases, no trustee in bankruptcy complies with state and city withholding and reporting requirements in the Southern District of New York at the present time. Again, except in rare instances, trustees in bankruptcy do not attempt to comply with federal reporting requirements. In effecting distribution to wage claimants, 25% of the gross wage claims being paid is deducted and transmitted by one check to the Director of Internal Revenue without attempting to allocate the proportion

[12] General Order 47. In *Nicholas* v. *United States*, 384 U.S. 478 (1966) the majority ruled that compliance by the debtor in possession with tax provisions requiring the filing of a return with respect to the income and social security taxes due there was not burdensome (at p. 695). The minority urged that the contrary may be true (at p. 700).

> of such 'withholding tax' to the various wage claimants for appropriate credit. The origin of this practice was not explained in the instant proceedings. The record was barren of any evidence of what is the practice in other districts.[13]

The referee gave no reason for rejecting the 25% rule. In operation, the 25% rule covered both the income tax due from a wage claimant on the wage claim distribution and the claimant's social security tax contribution. For example: the wage claimant's present social security tax contribution rate is 5.2%. Under the 25% rule, 5.2% would be credited to the claimant's social security account and 19.8% would be credited toward his income tax for the year.

Further evidence received by the court on behalf of the United States shows that the trustee would be required to file what an employer is now required to file each quarter. This is a return known as form 941 on which the employer reports 1) total wages subject to withholding, 2) total amount of income tax withheld, 3) total of wages subject to social security taxes, 4) total security taxes, 5) each employee's social security number, 6) name of each employee, and 7) total of each employee's taxable social security wages (Government's Exh. B). The importance of this form is that it advises the Government of social security credits earned by an employee. The information on this form is sent to the Social Security Administration's main office in Baltimore, Maryland.

The employer is also required at the end of the year to file with the taxing authorities a form W-3 indicating the withheld income taxes for each quarter. In this case the trustee would file this form for the quarter in which the wage dividends are paid.

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[13] Referee's Opinion, p. 11.

An employer is also required at the end of each year to prepare and file for each employee an employee's wage and tax statement known as form W-2 and to give this form with required copies to the employee. The employee is required to attach same from each employer to his income tax return for the year in which wages payments are received. This form is familiar to every wage or salary earner. It requires the employer to give thereon the following information as to an employee: a) federal income tax withheld; b) wages paid subject to withholding in the year in question and any other compensation; c) state and city income tax withheld; d) social security tax withheld; e) total social security wages paid in the year in question; f)) marital status of the employee; g) employee's social security number.

The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee off the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office.

The trustee's accountant also testified that the calculation of the proper taxes and the preparation of the required forms would be difficult because the trustee must first ascertain the present number of exemptions to which an employee may be entitled and his present annual income. The trustee's accountant further testified that compliance with tax provisions is expensive and burdensome because the trustee does not have the staff to make the required calculations or prepare required forms.

The trustee, however, failed to prove that services of an accountant as opposed to a clerk are required either for making the necessary 25% tax calculations or for preparing the required forms. Further, the trustee failed to prove that the employer's payroll records were not available for the purpose of securing therefrom the social security numbers of the 413 wage claimants. Schedule A-1 attached to the bankrupt's petition for an arrangement clearly indicates that its payroll records for the 413 wage claimants are available. Proper social security numbers are necessary not only for income tax purposes but for the proper crediting of the employee's social security account. The evidence showed that in the event a form 941 is filed without social security numbers and the employer is unable to furnish them a search is made for the employees by the district office of IRS in which the employees reside.

In response to the trustee's claim that it would be essential to know a wage claimant's presently claimed exemptions in order to compute the tax, the Government's evidence established that the 413 wage claimants are to be treated as persons with a second job. This means that if exact calculations are desired in lieu of the 25% rule, these income tax calculations are to be made without reference to exemptions or marital status. 26 U.S.C. § 3402(m)(3)(B). The evidence was that a person with more than one job would claim exemptions only with the prime employer so that there would not be under-withholding of taxes at the end of the year. He would file a certificate claiming zero exemption with the second employer.

Moreover, the Government contends, and the trustee does not deny, that exact income tax calculations need not be made under present IRS policy. The IRS has long since accepted, as the referee noted, the single rate deduction of 25% to cover both income and social security taxes for each employee. If too much income or social security taxes are by this method withheld from an employee, he is, of course,

entitled to claim a refund for overpayment on his income tax return for the year when he receives his wage claim dividend. In order to secure these refunds, it is necessary for the employee to have a form W-2 showing such withheld income and social security taxes.

In the past whenever a trustee in bankruptcy sent to the IRS a check representing 25% of the gross wage claims paid by him, the IRS prepared the forms (Tr. p. 80). These forms were prepared by the Special Procedures Section which files the Government's proofs of claim in bankruptcy and handles all bankruptcy litigation. The Government now takes the position that these forms should be prepared by the trustees in bankruptcy.

With respect to the 25% flat rate rule the trustee simply argued that application of such rule would be unfair to the wage claimants because most claimants would have too much tax withheld and would then have the burden of applying for a refund.

Evidence received on behalf of the City of New York revealed that the trustee would be required to file with it two simple reporting forms (City's Exh. 1 and 2). The only information sought by the City's forms relates to income taxes withheld and amounts paid to the City during the year.

As a result of the further evidence adduced, this court finds that compliance with federal and city tax provisions by utilizing the existing 25% rule is not unduly burdensome or expensive. Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment. Consequently, failure of a trustee to comply with tax provisions cannot be predicated on the ground that compliance is so contrary to the objective of efficient expeditious and economic administration of bankruptcy that it ought not be required of trustees.

We now come to the legal issues. The first question is whether taxes are required to be withheld by the trustee

upon the payment of wage claims which accrued prior to any bankruptcy proceeding. In *United States* v. *Fogarty, supra,* the Eighth Circuit, in a well reasoned persuasive opinion with which this court agrees, ruled that the payment of such wage claims is the payment of wages within the meaning of the Internal Revenue Code and that the trustee, as the person controlling the payment of such wages, is required by that Code to withhold federal income and social security taxes. 26 U.S.C. § 3121(a), (b), 3401 (d). Although this Circuit has not passed directly on this question in a bankruptcy case, in *Educational Fund of the Electrical Industry* v. *United States,* 426 F.2d 1053 (2d Cir. 1970), it agreed with the latter holding of the Eighth Circuit in another context and held that the person having control of the payment of the wages in lieu of an employer is obligated to withhold federal income taxes.

The second question is whether the trustee is bound to prepare and file form 941 and prepare, file and distribute to each wage claimant form W-2. In *Nicholas* v. *United States,* 384 U.S. 678 (1966), the Court held that a superseding trustee in bankruptcy is liable for penalties assessed by federal taxing authorities for failure to file tax returns on income and social security taxes withheld but not paid by the debtor in possession during an arrangement proceeding under Chapter XI. [It expressly left open the question whether a trustee in bankruptcy must file returns for the bankrupt for taxes "incurred" before bankruptcy (at p. 692 fn. 27).] There the Court said: "It is conceded that the trustee, in his status as representative of the bankrupt estate and successor in interest to the debtor in possession, is liable for the principal of the taxes incurred by the debtor in possession, to the extent of the priority enjoyed by taxes under 64a(1) of the Bankruptcy Act. Once that liability is established, there can be no question that, under § 6011(a) of the Internal Revenue Code, the trustee was under an obligation to file returns for these taxes, even

though the taxes themselves were incurred by the debtor in possession during the pendency of the arrangement proceeding" (at pp. 692-693). Following that reasoning of *Nicholas* v. *United States, supra,* and the reasoning of *United States* v. *Fogarty, supra,* that the trustee steps into the shoes of the bankrupt as employer for the purposes of paying pre-bankruptcy wages and withholding income and social security taxes thereon, this court holds that the trustee has the duty to file forms 941 and W-2.

The third and most difficult question necessary for decision on this review is whether the payment of the withheld taxes is entitled to a first priority under Section 64 (a)(1) of the Bankruptcy Act as costs and expenses of administration as the Government claims. In support of its claim the Government relies upon the *Fogarty* case. There the Eighth Circuit held that the withheld taxes should be allowed and classified as an expense of administration. In reaching its conclusion, the court was impressed by the fact that the taxes were not payable at the time the petition was filed by the bankrupt since the wages had not been paid. It was persuaded that the taxes only accrued, in the language of the social security statute,[14] "as and when" the wages are paid, that is, on the actual payment there of the wage claims. The Court said, and this seemed controlling, that the wage payments were made "during the administration of the estate pursuant to the orders of the bankruptcy court" (at p. 33). In short, the taxes accrued after bankruptcy commenced and were therefore entitled to a first priority as an expense of administration.

The Sixth Circuit in *United States* v. *Curtis, supra,* although it agreed with the Eighth Circuit that the trustee must withhold the taxes on the payment of wages earned

[14] 26 U.S.C. § 3102.

prior to bankruptcy, did not reach the question whether the payment of the taxes is entitled to a first priority. It expressly did not base its decision on the Eighth Circuit's view of this question.

The Seventh Circuit in *In re John Horne Co.*, 220 F.2d 33 (1955), noted that it was not "impressed" with the reasoning of the Eighth Circuit in granting a first priority to the payment of taxes on unpaid pre-bankruptcy wages but found no necessity to follow or reject that holding. The facts before that court were distinguishable. In the Seventh Circuit case the wages had been paid before bankruptcy. The taxes withheld thereon were unpaid. The court consequently had no problem in finding that those taxes were "legally due and owing" to the United States at the time of the filing of the bankruptcy claim and as such were entitled only to a fourth priority status.

In *Pomper* v. *United States,* 196 F.2d 211 (2d Cir. 1952) this Circuit dealt with the annual federal unemployment tax on employers which was a 3% tax on wages paid during the year. In that case the tax became due for the year in question after commencement of a Chapter XI proceeding. Although the tax was not payable until after the Chapter XI proceeding had commenced, the court held the tax divisible. It ruled that the tax was entitled to a first priority with respect to payment only as to those wages paid by the debtor in possession. As to those wages actually paid before bankruptcy, the court held that payment of the tax was entitled to only a fourth priority, even though the bankrupt's estate was insufficient to pay fourth priority claims. In assigning a fourth priority to that portion of the tax relating to pre-bankruptcy wages, the court pointed out that the amount of the tax for any specific period is computable by simple arithmetic based on wages paid to that point. Then the court said: "The mere fact that the tax is not due until the year's end does not detract from the fact that it is incurred in a readily as-

certainable amount as the wages are paid" (at p. 213). In short, although the tax was not payable to the Government until the end of a given year, the tax on wages paid before the end of the year were legally due and owing the United States because readily ascertainable.

The Ninth Circuit reached the same conclusion as the Eighth Circuit in *Lines* v. *State of California, supra,* with respect to payment by the trustee of that state's unemployment tax. The tax there had been imposed upon employers and was based upon the payment of wages earned within three months prior to bankruptcy but paid during bankruptcy.

The Third Circuit, however, parted company with the Eighth Circuit on the priority of payment issue in *In re Connecticut Motor Lines, Inc., supra,* and held that the withheld taxes are entitled only to a fourth priority. It had embraced, however, the Eighth Circuit's holding with respect to the duty and liability of the trustee to withhold taxes upon the payment of pre-bankruptcy wages (at p. 99, fn. 9).

This court is persuaded, as the Third Circuit was, that employee income and social security taxes withheld upon the payment of priority wage claims are not convincingly characterized as costs and expenses of administration but are more properly characterized as taxes "legally due and owing" the United States by the bankrupt, when attempting to fit them within the Section 64(a) scheme of priorities. These are neither taxes on activities involved in further developing or protecting the bankrupt's estate nor taxes imposed on the mere distribution of the wages, the chief characteristics of taxes denominated costs and expenses of administration.[15] These are taxes on wages for services performed for the bankrupt before the bankruptcy. They

[15] 40 N.Y.U. Law Rev. 360 (1965); 56 Mich. Law Rev. 631 (1958).

are not taxes imposed on any post bankruptcy activity. As the Third Circuit said, if the trustee can be cast in the role of bankrupt-employer for the purpose of the taxes attaching in the first place, as the Eighth Circuit ruled, it is difficult to see why he cannot also be bankrupt-employer for the purpose of determining by whom the taxes are owed for Section 64(a) purposes.

Section 64(a)(4) was amended after the Third Circuit case in 1966 to read that fourth priority shall be given to "taxes which *became* legally due and owing by the bankrupt" to any governmental body [Underlined portion added by amendment]. The Congress did not undertake to define the term "legally due and owing".[16] The question of what taxes "became legally due and owing" by the bankrupt was thus left to the courts. In *Matter of International Match Corp.*, 79 F.2d 203 (2d Cir. 1935), *cert. den. sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652, this Circuit had ruled that before a tax could be found to be legally due and owing by the bankrupt before bankruptcy enough must have been known about the basis of the tax to make the tax computable or "knowable" before bankruptcy, although not collectible until after adjudication. "The time of the accrual of the obligation to pay rather than the time when the obligation is to be discharged is the controlling feature" (at p. 205).

The taxes in question are a part of the wages due each employee. The obligation to pay those wages plainly accrued before bankruptcy. The fact that the wages are now to be paid after adjudication is, therefore, not controlling in determining when the tax obligation accrued. The tax obligation here accrued prior to bankruptcy along with the obligation to pay the wage earned prior to bankruptcy, although the taxes are not payable until the wages are paid.

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[16] U.S. Code Congressional and Administrative News, 1966, p. 2468. *In re Kopf*, 299 F. Supp. 182 (E.D.N.Y. 1969).

The Third Circuit in dealing with this issue first noted that, "It is well settled that the term 'legally due and owing' does not mean 'payable'" (at p. 104). It then resolved the tax uncertainty question by ruling that by reference to the annual wage of each employee, as disclosed by the bankrupt's records, a maximum tax figure is available for the purposes of provability under Section 64(a)(4).

This court also concurs with the Third Circuit that there has been a concerted legislative effort to reduce the significance of tax claims relative to other priorities under the Bankruptcy Act which justifies a fourth priority here. This view of the legislative trend was recently reaffirmed by the Supreme Court in *United States* v. *Randall, supra*. In the *Randall* case the bankrupt corporation was allowed to continue in business as debtor in possession. The order thus appointing the corporation required it to open three separate bank accounts for its general, payroll, and tax indebtedness and to make appropriate disbursements from those accounts. Withheld taxes were to be paid into the tax indebtedness account, but the debtor in possession failed to comply with the court's order. Income taxes from wage payments had been withheld by the corporation, but they had not been deposited in the special tax account or paid to the Government. When the corporation was later adjudicated a bankrupt the Government, which had previously filed a proof of claim in the Chapter XI proceeding for the payment of these taxes, moved in the bankruptcy court for an order allowing payment of these withheld taxes prior to payment of the costs and expenses of administration of the bankruptcy proceeding. The Government's theory was that the withheld taxes constituted a trust in favor of the United States. The referee denied the Government's claim. This denial was affirmed by the District Court and the Court of Appeals for the Seventh Circuit. The United States Supreme Court granted certiorari because of a conflict among the circuits. In affirming the lower court's decision

in *Randall* the Court ruled that the Bankruptcy Act is an overriding statement of federal policy on the question of priorities. It then quoted from that part of Section 64(a)(1) of the Act which gives priority to the costs and expenses of administration of a superseding bankruptcy over the costs and expenses of administration of the superseded Chapter XI proceeding. The Court there pointed out that until 1926 taxes were placed ahead of costs and expenses of administration. However, in that year Section 64 was amended to place costs and expenses in the first priority and taxes legally due and owing from the bankrupt in the fourth priority. And in 1952 the Section was again amended to give priority to administrative costs and expenses of a superseding bankruptcy over costs and expenses of a Chapter XI proceeding. The Court said: "We have then a progressive legislative development that (1) marks a decline in the grant of a tax preference to the United States and (2) marks an ascending priority for costs and expenses of administration."

Here the Government has filed a proof of claim for the taxes due on those wages actually paid in the three month period preceding bankruptcy (Claim 441). It admits that these taxes are entitled to only a fourth priority as taxes which became legally due and owing by the bankrupt before bankruptcy. If the taxes due on the wages actually paid are entitled to only a fourth priority, why should the taxes on wages earned but simply not paid during that period be entitled to a higher priority? To assign a first priority to the later group of taxes would make those taxes payable ahead of the wages, themselves, which are entitled to only a second priority.

The fourth question is whether the Government's claim here is barred by failure to file a proof of claim. The Third Circuit said: "The mere fact of payment after the filing does not, for bankruptcy purposes, lessen the ability of the Government to file a proof of claim. Because a maximum

figure is ascertainable, though subject to reduction, an adequate proof of claim can be filed" (at p. 106). The Third Circuit thereupon barred the Government's claim on the ground that it had failed to file a proof of claim, in apparent reliance upon the *Fogarty* case. This court agrees with the Third Circuit that the amount of the taxes due here are readily ascertainable but by a different method. It disagrees with the Third Circuit that the Government's claim is barred by its failure to file a proof of claim. With all due respect, this court finds that holding by the Third Circuit incongruous.

Here the total of the unpaid wages were scheduled by the bankrupt. The Chapter XI petition filed herein on September 15, 1964 reads: "There are approximately $80,000 in wages due employees as set forth in the debtor's payroll records for the four-month period immediately preceding the filing" (Schedule A-1). Thereafter, and within the six months allowed for the filing of such claims (11 U.S.C. § 93), 413 wage claims were filed against the $80,000 figure. These 413 claims have been checked by the trustee (in some instances they were contested) and approved by the referee for payment. The referee's order approving payment of these claims without withholding therefrom employee social security and income taxes is the order now before this court for review. When the wage claimants filed their proofs of claim, each such claim was for the full amount due that employee. It was not a claim for the full amount less the taxes due thereon. The trustee and the referee thus had before them a claim in each instance which included the Government's claim. By the simple expedient of applying the long standing 25% rule to each claim, the amount of the taxes due is readily ascertainable. If the amount of wages due each employee is known and can therefore be made the basis of a proof of claim, it is difficult to see why

the income and social security taxes due thereon are not proved by the same piece of paper.[17]

The purpose of requiring a proof of claim before any payment can be made from the estate of a bankrupt is obvious. 11 U.S.C. § 93. The estate must be protected against incorrect or fraudulent claims. When an employee files his proof of claim for the total of his pre-bankruptcy wages, the requirement of proof of claim before the Government can be paid its taxes has plainly been met. To require the Government to file another proof of claim with respect to those same wages does not appear to have been mandated by the Congress. The Government is entitled to taxes only on those wage claims actually filed, proved and paid. This is why there is uncertainty about the amount of taxes due. It is not an uncertainty arising from an inability to compute or know the tax on the day the bankruptcy petition is filed. It is an uncertainty arising from an inability to know who will file a proof of claim. Once a proof of claim is filed by a wage earner, all uncertainty ends. And the requirement that the Government file another proof of claim is simply a hypertechnical construction of the proof of claim requirement. In the case of taxes due on wages *actually paid* in the pre-bankruptcy period, the Government obviously must file a proof of claim since no proofs of claim would be filed by the wage earners involved. Here, however, the situation is different. Proof of claim must be filed by each wage earner before the Government can recover its taxes. This court therefore holds that a second proof of claim by the Government is not required.

The final question is whether New York City is entitled to have a 1% income tax withheld from each wage distribution for its benefit. New York City did not enact any income tax law until 1966. Manifestly there were no taxes

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[17] 40 N.Y.U. Law Rev. 360, 364 (1965).

that could be said to be legally due and owing to the City of New York by the bankrupt in any sense in September 1964 when the Chapter XI proceeding was filed. Since the bankrupt owed no "knowable" or computable tax to the City in 1964, the City has no claim enforceable in bankruptcy. *Matter of International Match Corp., supra.*

For the reasons set forth above, the decision and order of the referee are reversed and the trustee should be directed by the referee to: 1) withhold each employee's federal income and social security tax contribution from each wage claim distribution; 2) furnish each employee with the required W-2 form; 3) file the required form 941 and W-3; and 4) pay the withheld taxes to the United States.

Submit order on five days notice.

Dated: New York, New York
February 29, 1972

CONSTANCE BAKER MOTLEY
U.S.D.J.

Order in Bankruptcy

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64-B-727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Upon the proceedings before this Court on January 20 and 21, 1972, and upon the proofs of claim filed in this estate and the record below and this Court having rendered its decision, which was filed February 29, 1972, it is hereby

ORDERED, that the petition by the City of New York to review the referee's order of February 26, 1971, is denied, and it is further

ORDERED, that the petition by the United States to review the referee's order of February 26, 1971, be and it hereby is granted, and the said order is reversed insofar as it pertains to federal taxes, and accordingly the referee is directed to order the trustee 1) to withhold from distributions to wage claimants a sum equal to twenty-five percent of each distribution, for each employee's federal income and Social Security tax contribution; 2) to furnish each employee with the appropriate W-2 form; 3) to file Forms 941 and W-3 with the Internal Revenue Service; and 4) to pay the withheld taxes to the United States, when Section 64 (a)(4) payments are allowed.

Dated: New York, New York
March 22, 1972

/s/ CONSTANCE BAKER MOTLEY
U.S.D.J.

Statutes Involved

Title 11, United States Code:

§ 67. Duties of Referees

a. Referees shall * * * (5) declare dividends and cause to be prepared dividend sheets showing the dividends declared and to whom payable;

§ 75. Duties of Trustees

a. Trustees shall * * *; (11) pay dividends within ten days after they are declared by the referees;

§ 93. Proof and allowance of Claims

a. A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim; the consideration therefor; whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor. * * *

j. Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

n. Except as otherwise provided in this title, all claims provable under this title, including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed.

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon * * * (8) contingent debts and contingent contractual liabilities;

§ 104. Debts which have priority

(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupt's in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of Title 18, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as

the court may allow. Where an order is entered in a proceeding under any chapter of this title directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by section 638, 778, or 883 of this title, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,*

That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 107 of this title: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

Title 26, United States Code:

§ 3102. Deduction of tax from wages

(a) Requirement.—The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. An employer who in any calendar quarter pays to an employee cash remuneration to which paragraph (7) (B) or (C) or (10) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar quarter is less than $50:

§ 3401. Definitions

(a) Wages.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

* * * * *

(d) Employer.—For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

§ 3402. Income tax collected at source

(a) Requirement of withholding.—Every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables. For purposes of applying such tables, the term "the amount of wages" means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table in subsection (b)(1):

§ 6001. Notice or regulations requiring records, statements, and special returns

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 6011. General requirement of return, statement, or list

(a) General rule.—When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

§ 6041. Information at source

(a) Payments of $600 or more.—All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments to which section 6042(a) (1), 6044(a) (1), or 6049(a) (1) applies, and other than payments with respect to which a statement is required under the authority of section 6042(a) (2), 6044(a) (2), 6045, 6049(a) (2), or 6049 (a) (3)), of $600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary or his delegate, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary or his delegate, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

§ 6672. Failure to collect and pay over tax, or attempt to evade or defeat tax

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully

fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalities provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable. Aug. 16, 1954, 736, 68A Stat. 828.

Order Allowing Certiorari

SUPREME COURT OF THE UNITED STATES

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC.,

Petitioner,

—v.—

UNITED STATES and THE CITY OF NEW YORK,

Appellants.

ORDER ALLOWING CERTIORARI. Filed January 21, 1974.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

In Re

FREEDOMLAND, INC.,

Bankrupt.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No.

In Re

FREEDOMLAND, INC.,

Bankrupt.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

William Otte, Trustee in Bankruptcy of Freedomland, Inc., prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Second Circuit rendered on June 8, 1973 affirming a judgment entered in the United States District Court, Southern District of New York which directed Petitioner to withhold taxes from wage claimants in connection with "priority" wage claim distributions made pursuant to 11 U.S.C. § 104 (a) (2), but reversing the judgment insofar as it provided that the withheld taxes be held subject to the fourth priority established under 11 U.S.C. § 104(a) (4), and directing that the taxes so withheld be held subject to the second priority established under 11 U.S.C. § 104(a) (2).

Opinion Below

The Opinion of the Court of Appeals is not yet reported.

Jurisdiction

The Decision of the Court of Appeals was rendered on June 8, 1973. The jurisdiction of this court is invoked under 28 U.S.C. § 1254.

Questions Presented For Review

1. Does a distribution in a bankruptcy proceeding pursuant to 11 U.S.C. § 104(a)(2) constitute "wages", payable by an "employer" to an "employee", which are subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code?

2. Assuming *arguendo* that such a distribution is subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the monies withheld in connection with the distribution be accorded fourth priority "tax claim" status pursuant to 11 U.S.C. § 104(a)(4), first priority "administration claim" status pursuant to 11 U.S.C. § 104(a)(1), second priority "wage claim" status pursuant to 11 U.S.C. § 104(a)(2), or "trust fund" status, or barred entirely as being the equivalent of a penalty?

3. Assuming *arguendo* that such a distribution is subject to the withholding tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the claims of the United States and the City of New York have been barred because no proofs of claim for the withholding taxes in issue were filed by them in the Bankruptcy Court?

4. Is compliance with the withholding and reporting requirements of the Internal Revenue Code and the New York City Administrative Code in connection with such a distribution inconsistent with the spirit of economy of the Bankruptcy Act and therefore inapplicable in bankruptcy proceedings?

Statutes and Authorities Involved

Title 11, United States Code:

§ 93j

§93 n

§ 103(a)(8)

§ 104(a)(1)

§ 104(a)(2)

§ 104(a)(4)

Title 26, United States Code:

§ 3102(a)

§ 3401(a)

§ 3401(d)(1)

§ 6001

§ 6011(a)

§ 6041

Statement of the Case

Freedomland, Inc. ("Freedomland") filed a petition for an arrangement under Chapter XI of the Bankruptcy Act in the United States District Court, Southern District of New York on September 15, 1964. On August 30, 1965, it was adjudicated a bankrupt.

During the statutory filing period for filing claims, 413 claims of $600.00 or less were filed by Freedomland's former employees in its bankruptcy proceeding on account of wages that had been earned by the claimants *prior* to September 15, 1964, the date on which Freedomland filed its Chapter XI petition. No proofs of claim for withholding, social security, or related payroll taxes relative to

these claims were filed by the United States or the City of New York during the statutory filing period, after the expiration of that period, or pursuant to the "bar order" entered in the bankruptcy proceedings which directed all taxing authorities having claims against Freedomland, or petitioner, to file their claims with petitioner's attorney or be "forever barred from making any claim against Freedomland's estate or the Trustee" [Petitioner].

Freedomland's bankruptcy schedules indicated that it owed $80,000.00 on account of priority wage claims. However, the schedules omitted to set forth the names, addresses, social security numbers, number of dependents or related information concerning the claimants to whom such amount was admittedly due, although it is possible that such information existed in forty-two filing cabinets of Freedomland's records located at a warehouse.

On November 7, 1969, petitioner moved for and was granted authority to make a distribution to Freedomland's 413 priority wage claimants by paying the claims in full without any requirement to: (1) withhold Federal, State or City taxes, (2) pay such taxes to the taxing authorities, (3) file tax returns with the taxing authorities, (4) furnish withholding tax statements to the claimants, or (5) pay any penalties to the taxing authorities for failure to withhold and pay or file tax returns in connection with the distribution. Petitioner's motion was granted on the ground, *inter alia,* that the withholding/reporting requirements of the taxing authorities were inconsistent with the object of efficient, expeditious, and economical administration of bankrupt estates. Thereafter, on appeal to the District Court, and after an evidentiary hearing in which petitioner presented evidence that compliance with the reporting and filing requirements of the taxing authorities would be burdensome and expensive, and that a flat 25% deduction for United States taxes would exceed the amount of tax that would be deducted if official tax tables were

used on known exemptions and past income, the District Court concluded that petitioner should be required to withhold United States but not New York City payroll related taxes in making wage claim distributions even though the United States had failed to file a proof of claim for such taxes in the bankruptcy proceeding. The District Court also directed that such taxes as were withheld should be accorded fourth priority status under 11 U.S.C § 104(a)(4), and that no tax need be withheld for New York City taxes because New York City's tax law did not become effective until 1966, after the date on which the wage claims accrued.

On appeal to the United States Court of Appeals for the Second Circuit, the court affirmed in part and reversed in part holding that taxes should be withheld for New York City as well as United States taxes, and that such taxes as were withheld should be accorded second priority status under 11 U.S.C. § 104(a)(2).

Reasons for Granting the Writ

Certiorari should be granted because of the conflict among the circuits as to the priority to be accorded withholding taxes on pre-bankruptcy wage claims under the Bankruptcy Act. The Eighth and Ninth Circuits in *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947) and *Lines* v. *State of California,* 242 F.2d 20 (9th Cir. 1957), *rehearing denied,* 246 F.2d 70, *cert den.,* 355 U.S. 857, accorded such withheld taxes a first priority under 11 U.S.C. § 104(a)(1). The Third Circuit *In Re Connecticut Motor Lines,* 336 F.2d 96 (3rd Cir. 1964) accorded such withheld taxes a fourth priority under 11 U.S.C. § 104(a)(4). Finally, the Second Circuit in the case at bar accorded such taxes a second priority under 11 U.S.C. § 104(a)(2), reversing the lower court decision which accorded such taxes a fourth priority under 11 U.S.C. § 104(a)(4). Moreover, a conflict exists among the circuits as to the

necessity for the United States Government and presumably other taxing authorities to file proofs of claim in connection with such taxes. The Third Circuit in *In Re Connecticut Motor Lines, supra.*, in apparent reliance of the Eighth Circuit holding in *Fogarty, supra,* held that tax claims in connection with withheld taxes on wage claims are barred pursuant to 11 U.S.C. § 93(n) unless the taxing authority in question files a timely proof of claim in connection with such taxes; whereas the court below concluded that the claims could be allowed even if no proofs of claim were filed. Finally, a conflict exists as to whether withholding taxes must be deducted at all in connection with priority wage claim distributions. Most of the circuits, including the court below, have concluded that they are, but the district court in *In Re Erie Forge & Steel Corp.*, United States District Court, Western District of Pennsylvania, No. 69-83, December 29, 1962 (unreported), has concluded that they are not. In this connection, the court is referred to the decision in the court below which concedes that an argument could be made that a wage claim distribution may not be the same thing as wages subject to withholding taxes (p. 4077), and the holding of the Second Circuit in *In the Matter of Kokoska,* United States Court of Appeals, Second Circuit, No. 496, September Term, 1972 (unreported), that notwithstanding that wages are entitled to a priority status in a bankruptcy proceeding, that "just because some property interest had its source in wages, however, does not give it special protection, for to do so would exempt from the bankrupt estate most of the property owned by many bankrupts * * * which had their origin in wages" (p. 3674). In other words, the Second Circuit itself concedes that a difference exists between "wages" and "wage claims" and in the absence of a definitive determination that wage claims are the equivalent of wages, no determination can or should be made that taxes should be withheld at all on wage claim distributions.

The decision in the court below also creates anomaly in its attempt to distinguish this court's holding in *United States* v. *Randall,* 401 U.S. 513 (1971) from the case at bar. *Randall* held that where a wage claim has actually been paid the tax to be withheld on the wage claim distribution does not fall into the same priority status under the Bankruptcy Act as the wage claim itself; whereas the court below held that where the wage claim has not been paid, that it does. The anomaly is compounded by the provisions of 11 U.S.C. § 104(a)(4) which accords a fourth priority to taxes on wages actually paid prior to bankruptcy, whereas the holding of the court below accords second priority status to taxes on wages paid after bankruptcy. In this connection, the Seventh Circuit in *In Re John Horne Co.,* 220 F.2d 33 (7th Cir. 1955), relying somewhat on *Pomper* v. *United States,* 193 F.2d 211 (2d Cir. 1952), both dealing with wages actually paid before bankruptcy, held that the taxes relative to such wages should be accorded fourth priority status under 11 U.S.C. § 104(a)(4).

CONCLUSION

It is respectfully submitted that the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX A—DECISION OF

United States Court of Appeals

FOR THE SECOND CIRCUIT

Nos. 427, 804, 805—September Term, 1972.

(Argued March 15, 1973 Decided June 8, 1973.)

Docket Nos. 72-1546, 72-1551, 72-1716

In re Freedomland, Inc.

Bankrupt

Before:

HAYS, MULLIGAN and OAKES,

Circuit Judges.

Appeal from a judgment in the Southern District of New York, Constance B. Motley, *Judge*, (1) ordering the bankruptcy trustee to withhold taxes and file necessary forms on wages earned but not paid prior to bankruptcy; (2) assigning the taxes a fourth priority as "taxes due and owing by the bankrupt," 11 U.S.C. § 104(a)(4); and (3) denying New York City's claim for withheld taxes on the ground that the City's income tax was passed after the date the wages were earned.

Affirmed in part, reversed and remanded in part.

HOWARD KARASIK, New York, New York *for Appellant Otte, Trustee in Bankruptcy of Freedomland, Inc.*

SUSAN FREIMAN, Assistant United States Attorney (Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, on the brief) *for Appellant United States.*

SAMUEL J. WARMS, New York, New York (Norman Redlich, Corporation Counsel for the City of New York, Raymond Herzog and Cornelius F. Roche, of counsel), *for Appellant New York City.*

OAKES, *Circuit Judge*:

This case presents the esoteric, but nevertheless highly practical, issue of how withholding on wages earned before bankruptcy is to be handled in bankruptcy. Involved are both the income tax laws, silent in this regard as to the effect of bankruptcy, and the bankruptcy laws, silent as to the status of moneys withheld and indeed inarticulate as to the category of priority within which *previously* earned wages fit. The problems presented in winding a tortuous path between two inexact sets of statutes in these two different areas of law as to withholdings claimed due the United States are further complicated by virtue of a claim for income tax withholdings by the City of New York on a statute enacted *after* the wages were earned but before any payments on their account to the wage earners have been made by the bankruptcy trustee.

Freedomland, Inc., filed an arrangement petition under Chapter XI of the Bankruptcy Act on September 15, 1964, and was adjudicated a bankrupt on August 30, 1965. During the statutory period for filing claims, 413 claims of $600 or less, totaling approximately $80,000, were filed by former employees of Freedomland on account of wages earned *before* the filing of the Chapter XI petition. 11

U.S.C. § 93. No claims for withholding, social security or related taxes were filed either by the United States or the City of New York during the statutory filing period or otherwise.[1] The trustee, on November 7, 1969, moved the referee for an order authorizing payment to the wage claimants without withholding income, social security or other taxes and an order specifically declaring that he was not required (1) to make any such payments to any governmental body; (2) to prepare, distribute or file wage and tax statements for the employees or as an employer; or (3) to pay any penalties. The referee, Edward J. Ryan, was apparently much taken with the criticism by a fellow referee of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), which held that a trustee must withhold income and social security taxes and that the taxes were payable as an administration expense entitled to first priority.[2] Referee Ryan accordingly on January 27, 1971, granted the trustee's petition on all counts, holding that "compliance with withholding and reporting requirements of tax authorities

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[1] The United States had filed a claim for federal income and social security taxes due on wages *actually paid* during the quarter immediately preceding the petition for an arrangement. No claim was filed for those due on *unpaid* wages during that quarter, however, and it is withholdings on those wages which are in dispute here.

[2] *See* Hiller, *The Folly of the Fogarty Case,* 32 J. of Nat'l Ass'n of Ref. 54 (1958).

In general terms § 64(a) of the Bankruptcy Act, 11 U.S.C. § 104, categorizes debts having priority in the following order:

1. costs and expenses of administration;
2. wages not exceeding $600 earned within three months before the date of the commencement of the proceeding;
3. creditor's expenses in setting aside confirmation of an arrangement or obtaining refusal of a discharge;
4. "taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof . . . ." and
5. debts owing to persons entitled to property by law.

is utterly inconsistent with the spirit and the letter of the Bankruptcy Act," particularly the policy in favor of "efficient, expeditious economic administration of bankrupt estates."

The district court took evidence on the question what administrative burdens were imposed by the requirement that taxes were to be withheld, paid over and duly accounted for by the bankruptcy trustee. The district court noted (as the referee had previously) a bankruptcy practice in the Southern District of New York, concurred in by IRS, of deducting 25 per cent of gross wage claims, covering both income and social security taxes, and paying it in one check to the Director of Internal Revenue without allocation to the various individual taxpayers. Further evidence indicated that a junior accountant or clerk with payroll records could make the 25 per cent calculations quite readily and could also fill out forms 941 and W-3 for the Government and forms W-2 for the individual employees respectively. On the basis of this evidence the district court, in an opinion printed at 341 F. Supp. 647 (S.D.N.Y. 1972), reversed the referee's order that the trustee was not required to withhold taxes or file the necessary forms. The court then went on to hold, relying upon *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), that withholdings were not "expenses of administration" as held in *United States* v. *Fogarty, supra,* but rather were entitled only to a fourth priority as taxes "legally due and owing" to the United States by the bankrupt. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4). In reaching this decision, the court also referred to *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), *cert. denied sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652 (1935), for the proposition that "before a tax could be found to be legally due and owing by the bankrupt . . . enough must have been known about the basis of the tax to make the tax computable or 'knowable' before bankruptcy, although not collectible until after ad-

judication." 341 F. Supp. at 656. As to the City of New York's claim, the district court held that since the City tax was not even enacted until 1966 [3] there were no taxes that could be said to be legally due and owing to it in September, 1964, when the Chapter XI proceeding was filed, and hence the City had no claim, under *In re International Match Corp., supra.* For the reasons which we state hereafter, we agree with the district court insofar as it required withholding and filing the prescribed forms, but disagree as to the order of priority assigned by it to withholdings, as well as to its treatment of the claim of the City of New York.

The first issue is whether a bankruptcy trustee must withhold under federal income tax law. The Internal Revenue Code of 1954, § 3401(a) defines "wages" as "all remuneration . . . for services performed by an employee for his employer. . . ." Were we to face this question afresh, an argument might be made that payments made by a bankruptcy trustee for wages earned before bankruptcy are really wage claim distributions. For example, as pointed out to us by the trustee, a solvent employer required to pay a judgment for disputed wages earned might not be paying "wages." *Cf.* Rev. Rul. 55-520, 1955 Int. Rev. Bull. No. 2 at 393-94 (compromise settlement for cancellation of employment contract not wages for withholding or FICA); Rev. Rul. 69-136, 1969 Int. Rev. Bull. No. 1 at 252-53 (sums paid former employees while in military service not wages). Further, it could be advanced that the bankruptcy trustee is not an "employer" since he has no "right to control and direct," 26 C.F.R. § 31.3401(c)-

[3] New York City has had since July 1, 1966, a tax on residents as well as nonresidents earning wages in New York that tracks the federal tax (with limited immaterial modifications), New York City Admin. Code § T46-11.0, 12.0, and contains appropriate withholding provisions. New York City Admin. Code, Ch. 46, Titles T (residents) and U (non-residents). The rate of the tax is agreed upon here as 1 per cent.

1(b), the "individual performing services," 26 C.F.R. § 31.3401(c)-1(a), that is, the wage claimant. *See In re Park Brewing Co.*, 49 F. Supp. 750 (W.D. Mich. 1942). *But see* Int. Rev. Code of 1954, § 3401(d)(1) (defining "employer" as "the person having control of the *payment* of . . . wages . . . ." [emphasis supplied]);[4] *Educational Fund of the Electrical Industry* v. *United States*, 426 F.2d 1053 (2d Cir. 1970) (payments to union members attending school which under collective bargaining agreement derived from employers but were paid out by union trust denominated as "educational fund" constituted "wages" for withholding, and educational fund held to constitute "employer" under § 3401(d)(1)).

We are not writing on a clean slate, however. *United States* v. *Fogarty, supra,* decided in the Eighth Circuit has been followed first in the Sixth, *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950), and then in the Ninth Circuits on this point. *Lines* v. *State Department of Employment,* 242 F.2d 201 (9th Cir.), *rehearing denied with opinion,* 246 F.2d 70, *cert. denied,* 355 U.S. 857 (1957). *See also In re Connecticut Motor Lines, Inc.*, 217 F. Supp. 330 (E.D. Pa.), *supplemented* 223 F. Supp. 189 (1963), *rev'd on other grounds,* 336 F.2d 96 (3rd Cir. 1964). While *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field,[5] there is no decision of any court outstanding to the contrary on the point of necessity of withholding.

Indeed, as was found below, until it was decided to make a test case of this one—and we are appalled that

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[4] The trustee suggests that he does not have "control" because payment requires an order of the court and the referee's countersignature. But the trustee applies for the order and has title to the funds to be paid, and when he sends the checks out he surely has "control of the payment."

[5] 3A Collier on Bankruptcy ¶ 64.202 at 2119 n.1 (14th ed. 1972); Hiller, supra note 2.

almost nine years elapsed from the time the wages were earned until the case came to us [6]—the bankruptcy trustees, at least in the Southern District of New York, managed perfectly well with the rough deduction of 25 per cent and remittance of that sum to the Director. The trustee's and referee's parade of horribles relating to computations, employment of accountants, completion of forms, etc., was quite deflated by the court below in its findings,[7] and especially its conclusion that "Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment." 341 F. Supp. at 654. The result in Fogarty at least has the virtue that wage earners themselves do not have the job of determining their individual FICA taxes or figuring how to report them so as to obtain full social security credit therefor.

It may be that a dust cloth will be needed to wipe the cobwebs away from the files in which the wage and payroll records for the quarter in question are stored, now that so much time has gone by, but the amount of effort required on the trustee's part in a bankruptcy matter involving the sums that this one does is relatively small, even though 413 wage claimants are involved. That effort prob-

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[6] In this connection it might be noted that even the referee whose criticism of *Fogarty* was heavily relied on by the referee here refused to create a test case challenging the *Fogarty* rule in his circuit because he realized the "hardship that a protracted delay would entail" to the needy coal miners involved in his case. Hiller, *supra* note 2, at 54.

[7] The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee of the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office. 341 F. Supp. 647, 653.

ably doesn't begin to match that which will be required of a conscientious trustee to track down the present addresses of the former employees so that they may receive their long overdue wages in the mail, effort which could largely have been avoided had distributions been made when they first could have been, several years ago. We thus hold that the trustee, as a person who substantially controls the payment of wages, Int. Rev. Code of 1954, § 3401(d)(1), is an employer for withholding tax purposes and must withhold.

It follows that as employer the trustee must file the requisite forms, including 941, W-2 and W-3, as he was ordered to do below. *Cf. Nicholas* v. *United States*, 384 U.S. 678, 692-93 (1966) (trustee in bankruptcy held under an Int. Rev. Code of 1954, § 6011(a) obligation to file returns for taxes incurred by debtor in possession). We hold also that he may withhold on the 25 per cent basis which the court below found, with no real dispute here, represents an IRS attempt to facilitate bankruptcy administration on quite a practical basis. We see no objection to this commonsense approach, for if there is an overpayment the employee can file for a refund. Of course, as income or social security taxes change—and the latter have increased .65 per cent from 1971 to 1973—the 25 per cent may have to be adjusted slightly.[8] Perhaps Congress will

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[8] It should be remembered that these wage earners are in the highest degree of likelihood on the cash basis, Int. Rev. Code of 1954, § 446(a) & (c), so that the rates of tax in effect in the year of *payment* as opposed to the year of wage-earning or the year of the referee's order permitting payment govern. *Muhleman* v. *Hoey*, 124 F.2d 414, 415 (2d Cir. 1942); 2 Mertens, The Law of Federal Income Taxation § 12.42 at 179 (1973):

> The doctrine that payments of compensation are income to a taxpayer on a cash basis in the year of receipt, as distinguished from the year in which the compensation is earned, is too firmly embedded in the income tax law to permit of any question.
>
> Withholding of social security taxes is also done "by deducting the amount of the tax from the wages *as and when paid.*" Int. Rev. Code of 1954, § 3102(a) (emphasis supplied).

ultimately be of assistance here. But in any event the 25 per cent figure still seems a sound one and one easy to compute.

To which, if any, of the five priorities under § 64 of the Bankruptcy Act, note 2 *supra*, then, are withholdings on wage distributions to be assigned? The *Fogarty* case held that they should be classified as administration expenses, that is, in the first priority. *See also Lines* v. *State Department of Employment, supra.* But "the costs and expenses of administration," § 64(a)(1) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1), must in general relate to the preservation or development of the bankrupt's assets. *See, e.g., Adair* v. *Bank of America National Trust & Savings Association,* 303 U.S. 350, 361 (1938). We agree that the Third Circuit's criticism of *Fogarty* and *Lines* in *In re Connecticut Motor Lines, Inc., supra,* 336 F.2d at 99-102, *noted,* 63 Mich. L. Rev. 1103 (1965), 40 N.Y.U.L. Rev. 360 (1965), 19 Rutgers L. Rev. 546 (1965). *See also Denton & Anderson Co.* v. *Induction Heating Corp.,* 178 F.2d 841, 843-44 (2d Cir. 1949) (commissions accruing after bankruptcy on goods ordered but not filled prior thereto held *not* entitled to first priority status). By according (a)(1) status to withholding taxes they would take priority over the wages on which they were based. In *Lines,* indeed, dividends which would have gone to wage earners were depleted by an employer's tax payment to the unemployment insurance fund. *See* 56 Mich. L. Rev. 631, 633 (1958).

We do not agree, however, with the Third Circuit's treatment in *Connecticut Motor Lines* of withholdings as "taxes which became legally due and owing *by the bankrupt*" (emphasis supplied), and hence entitled to fourth priority treatment. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4).[9] The taxes are by law calculable only when the

[9] The Seventh Circuit reached the same result *In re John Horne Co.,* 220 F.2d 33 (7th Cir. 1955), relying somewhat on our own *Pomper* v. *United States,* 196 F.2d 211 (2d Cir. 1952). Both *Horne* and *Pomper,* however, dealt with wages actually paid before bankruptcy, not the case here. *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950).

wage claims are paid and not until then, note 7 *supra*, regardless of any practice by IRS to accept a flat payment of a specified percentage such as 25 per cent. The taxes were never "due and owing by the bankrupt," which was Freedomland.[10] When a tax "cannot be computed as of the date of the petition in bankruptcy," it is not "due and owing by the bankrupt." *In re International Match Corp., supra.*

We agree, rather, with the very persuasive brief of the City of New York that the proper classification for the withholdings to be made is that of second priority wage claims. All of the withholding taxes, whether federal or city, derive from the payments which will be made to the wage claimants. Int. Rev. Code of 1954, §§ 3402, 3101; New York City Admin. Code § T46-51.0 and § U46-8.0. The claimants are credited with the withheld amounts toward their income taxes. Int. Rev. Code of 1954, § 31(a); New York City Admin. Code § T46-53.0 and § 46-10.0. Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part. *Cf. In re Quakertown Shopping Center, Inc.*, 366 F.2d 95 (3rd Cir. 1966) (IRS can levy upon the claim of a taxpayer-creditor against a bankrupt estate without approval of bankruptcy court).

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[10] It is for this reason we reject the argument made by the Third Circuit, *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102-06 (3rd Cir. 1964), relied on by the district court here, 341 F. Supp. at 656-57, that a concerted legislative policy to reduce the priority of tax claims in bankruptcy requires a fourth priority classification for the withheld taxes here. The legislative policy discerned relates to taxes owed by the bankrupt, not by the bankrupt's employees. The fourth priority in bankruptcy relates historically and otherwise to taxes owed by the bankrupt. Similarly, the 64(a)(2) priority derives from 132 years of statutory history relating to the status of wage claims in bankruptcy, a history long precedent to the adoption in 1943 of what some will recall as "pay-as-you-go." Act of June 9, 1943, c.120 § 2(a), 57 Stat. 126, Int. Rev. Code of 1939, § 1621, as amended.

In our view when wage claims are ordered to be paid by the bankruptcy court they should be segregated and the tax monies due held as trust funds. Int. Rev. Code of 1954, § 7501(a); New York City Admin. Code § T46-55.0 and § U46-12.0. It is true that *United States* v. *Randall*, 401 U.S. 513 (1971) (5-4 decision), held that where a debtor in possession failed to obey an order of the bankruptcy court to deposit withheld taxes in a special tax account, the Bankruptcy Act's (a)(1) priority for costs and expenses of administration would override any claim pursuant to 26 U.S.C. § 7501(a) that the withheld taxes "shall be held to be a special fund in trust for the United States." *But cf. In re Airline-Arista Printing Corp.*, 267 F.2d 333 (2d Cir. 1959), and *City of New York* v. *Rassner*, 127 F.2d 703 (2d Cir. 1942), referred to in *United States* v. *Randall, supra*, 401 U.S. at 519 (dissenting opinion). *Randall*, however, did not reach the question before us. Rather, it was concerned only with vindicating the Bankruptcy Act's "policy of subordinating taxes to costs and expenses of administration." 401 U.S. at 517. That policy is fully upheld by placing the withheld taxes here in a second priority position along with the wages that create them. In other words, the trust which arises is subject to the prior payment of the statute-specified costs and expenses of administration, but exists nevertheless as to withholdings on wage claims allowed.[11] In this view, contrary to the view of the Third Circuit in *Connecticut Motor Lines, supra*, 336 F.2d at 107, there is no necessity for the Government (or City) to file proofs of claims for withholdings. Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt*, not the case here. The

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[11] The second sentence of § 7501 of the Int. Rev. Code of 1954 is consistent with this view:

> . . . The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. In this respect we agree with the court below.

There remains for consideration only the question whether New York City may obtain withholding taxes on the wage claims paid since there was not even a city income tax in effect when the wages were earned. But we have already pointed out that the wage earners here are in all probability on the cash basis, note 7 *supra,* so that regardless of when the wages were earned, they are income and taxable in the year received. As we have already said, liability for withholding arises when the wage claims are paid. Int. Rev. Code of 1954, §§ 3402, 3101 and 31(a). The City in this respect is in the same position as the federal government. New York City Admin. Code §§ T46-51.0 and U46-8.0; §§ T46-53.0 and U46-10.0. Wages are just as much a part of city "adjusted gross income," New York City Admin. Code § T46-12.0, as they are of federal. The fact that the city tax applies to wages earned before its effective date is not important since no vested rights are impaired. *See Welch* v. *Henry,* 305 U.S. 134, 146-51 (1938); *Milliken* v. *United States,* 283 U.S. 15, 20-24 (1931); *Kentucky Union Co.* v. *Kentucky,* 219 U.S. 140, 152-53 (1911) ("Laws of a retroactive nature, imposing taxes . . . and not impairing vested rights, are not forbidden by the Federal Constitution"). *See also Lynch* v. *Hornby,* 247 U.S. 339 (1918) (federal income tax law constitutionally permits taxation of dividends paid out of surplus accumulated before date of act); *Neild* v. *District of Columbia,* 110 F.2d 246, 253 (D.C. Cir. 1940). We conclude that the City is as entitled to its withholding tax as the federal government is to its taxes.

We add only that to the extent there is now a conflict among the circuits as to priorities of withholding taxes on

pre-bankruptcy wages earned—the Eighth and Ninth Circuits going for the first, the Third for the fourth and the Second for the second—correction may come either from Congress or the High Court. It is a pity that the wage claimants here had to wait so long for the case to wend its way to our court, and that so many of them were involved. Nevertheless the question has some significance in the administration of bankrupt estates so that it is perhaps well that after the 25 years that have elapsed since *Forgarty* the matter might receive some further congressional or judicial attention.

We reverse and remand for the entry of judgment in accordance with this opinion.

APPENDIX B

Title 11, United States Code:

§ 93. Proof and allowance of Claims

(j) Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

(n) Except as otherwise provided in this title, all claims provable under this title, including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed.

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon (8) contingent debts and contingent contractual liabilities;

§ 104. Debts which have priority

(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit

of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of Title 18, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this title directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by section 638, 778, or 883 of this title, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include

all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 107 of this title: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

Title 26, United States Code:

§ 3102. Deduction of tax from wages

(a) Requirement.—The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by de-

ducting the amount of the tax from the wages as and when paid. An employer who in any calendar quarter pays to an employee cash remuneration to which paragraph (7) (B) or (C) or (10) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar quarter is less than $50:

§ 3401. Definitions

(a) Wages.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

(d) Employer.—For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

> (1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

§ 6001. Notice or regulations requiring records, statements, and special returns

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such per-

son or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 6011. General requirement of return, statement, or list

(a) General rule.—When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

§ 6041. Information at source

(a) Payments of $600 or more.—All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments to which section 6042(a) (1), 6044(a) (1), or 6049(a) (1) applies, and other than payments with respect to which a statement is required under the authority of section 6042(a) (2), 6044(a) (2), 6045, 6049(a) (2), or 6049 (a) (3)), of $600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary or his delegate, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary or his delegate, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, TRUSTEE IN BANKRUPTCY OF FREEDOMLAND, INC., PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court is reported at 341 F. Supp 647. The opinion of the court of appeals (Pet. App. A) is reported at 480 F. 2d 184.

JURISDICTION

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED[1]

1. Whether a trustee in bankruptcy is required to withhold federal taxes from payments of wage claims

[1] Petitioner also raises questions with respect to the proper treatment of New York City withholding taxes. We discuss only the issues pertaining to the United States.

made under Section 64(a)(2) of the Bankruptcy Act and to complete the appropriate information reports and returns with respect to the amounts withheld.

2. Whether the United States must file a proof of claim with respect to such withholding taxes.

3. Whether the withholding taxes on priority wage payments constitute first, second, or fourth priority debts under Section 64(a) of the Act.

STATUTES INVOLVED

The pertinent provisions of Sections 57, 63, and 64 of the Bankruptcy Act, 11 U.S.C. 93, 103, and 104, and Sections 3102 and 3401 of the Internal Revenue Code of 1954, 26 U.S.C. 3102 and 3401, are set forth at Pet. App. B, pp. 14a-17a.

STATEMENT

Freedomland, Inc., was adjudicated a bankrupt in August 1965. During the following six-month statutory period for filing claims in bankruptcy (see 11 U.S.C. 93(a)), 413 former employees of Freedomland filed claims for wages of $600 or less earned within six months prior to the filing of the bankruptcy petition and for which they were entitled to priority of payment under Section 64(a)(2) of the Bankruptcy Act, 11 U.S.C. 104(a)(2). These wage claims totalled approximately $80,000. As is its customary practice, the United States filed claims only for the taxes actually owing by the bankrupt at the time the petition was filed; the United States did not file claims for the withholding taxes which would become due if and when the priority wage claims were paid.

Petitioner, the trustee in bankruptcy of Freedomland, requested permission of the bankruptcy referee to pay

the priority wage claims without withholding any federal taxes. The referee authorized petitioner to make such payments without any withholding and further held that petitioner was not required to file with the Internal Revenue Service any tax returns or other reports with respect to those payments.

The government appealed from the referee's order to the United States District Court for the Southern District of New York, and that court reversed, holding that petitioner was required to withhold federal income and F.I.C.A. taxes from priority wage payments, to complete the appropriate information reports and returns with respect to such withholding, and to pay the amounts withheld to the United States as a fourth priority claim under Section 64(a)(4) of the Bankruptcy Act.[2] The court stated that the wage claims filed by the employees had been sufficient to apprise petitioner that federal withholding taxes would be due and payable, and therefore that the United States was not required to file claims with respect to such taxes during the six-month statutory period. The court of appeals substantially affirmed, but disagreed with the district court concerning the priority to be accorded the government's claim for withholding taxes, holding that such taxes are payable as second priority claims under Section 64(a)(2) of the Bankruptcy Act.

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[2] The court held that, to facilitate bankruptcy administration, petitioner could meet the withholding requirement by keeping back a flat 25 percent of the gross wages instead of following the withholding tables set forth in Section 3402 of the Internal Revenue Code of 1954, 26 U.S.C. 3402. The government favors this practice.

DISCUSSION

I. The courts below correctly held that a trustee in bankruptcy must withhold federal income and F.I.C.A. taxes from priority wage payments and complete the appropriate information reports and returns with respect to the amounts withheld.

a. Sections 3402 and 3102 of the Internal Revenue Code of 1954, 26 U.S.C. 3402 and 3102, require every employer making payment of wages to deduct and withhold federal income and F.I.C.A. taxes.[3] Petitioner claims that he is not an "employer" and that priority wage claim distributions do not constitute the payment of "wages."[4] But the term "wages" is defined broadly for withholding purposes as "all remuneration for employment" (Sections 3121(a)(1) and 3401(a) of the Code) and "employer" is defined by Section 3401(d) as either the person for whom the employee performed services or, if such person does not have control of the payment of wages, the person having such control.

The priority wage claim distributions to the former employees of Freedomland constituted remuneration for past employment and petitioner was the person having control of such payments. Petitioner therefore was subject to the withholding provisions of the Code. Cf. *Social Security Board* v. *Nierotko*, 327 U.S. 358. Indeed, as the court of appeals below noted (Pet. App. A, p. 6a) and as petitioner concedes (Pet. 6), the

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[3] Section 7501 of the Code further requires that the amounts so withheld be held by the employer in trust for the United States.

[4] Such distributions, of course, constitute taxable income to their recipients.

courts of appeals have uniformly held that priority wage claim distributions in bankruptcy are subject to withholding. *United States* v. *Fogarty,* 164 F. 2d 26 (C.A. 8); *United States* v. *Curtis,* 178 F. 2d 268 (C.A. 6), certiorari denied, 339 U.S. 965; *Lines* v. *California Department of Employment,* 242 F. 2d 201 (C.A. 9), certiorari denied, 355 U.S. 857; *In re Connecticut Motor Lines,* 336 F. 2d 96 (C.A. 3).[5]

b. It follows from petitioner's responsibility to withhold that he must also complete the appropriate information forms and returns with respect to the amounts withheld. See Sections 6011 and 6051 of the Code; *Nicholas* v. *United States,* 384 U.S. 678, 692-695.

2. The courts below also correctly held that the United States is not required to file a prior proof of claim with respect to withholding taxes on priority wage payments. Proofs of claim are required only with respect to "[d]ebts of the bankrupt * * *." Section 63(a) of the Bankruptcy Act, 11 U.S.C. 103(a). Withholding taxes on priority wage distributions are not debts of the bankrupt. The withholding taxes here at issue were not legally due and owing by Freedomland when it filed its bankruptcy petition; they became due only when the wages were actually paid by petitioner. See, *e.g., In re International Match Corp.,* 79 F. 2d 203 (C.A. 2), certiorari denied *sub nom. Delaware* v. *Irving Trust Co.,* 296 U.S. 652. There was, therefore, no outstanding liability for the withholding taxes at

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[5] Furthermore, we have been advised by the Internal Revenue Service that bankruptcy trustees generally consider themselves obligated to withhold federal income and F.I.C.A. taxes from priority wage payments and do so. The issue, therefore, is not frequently litigated.

the time of the bankruptcy adjudication; with respect to these taxes, there was no debt of the bankrupt for which a proof of claim could have been filed. Moreover, as the court of appeals below stated (Pet. App. A, pp. 11a-12a):

> * * * it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt,* not the case here. The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholding due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. [Emphasis in original.]

The decision below on this issue conflicts with that of the Third Circuit in *In re Connecticut Motor Lines, supra,* which held that the government must file a proof of claim with respect to the withholding taxes on wages accrued but not paid prior to bankruptcy. The decision in *Connecticut Motor Lines* was based on the theory that such withholding taxes were, in a constructive sense, legally due and owing by the bankrupt. While that theory has not been followed in any other circuit, the underlying issue is one of substantial importance to the collection of revenues from bankrupt's estates.[6]

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[6]While the district court below agreed with *Connecticut Motor Lines* that withholding taxes on priority wage claims are constructively due and owing by the bankrupt, it held that the government nevertheless was not required to file a proof of claim. The district court reasoned that, since the purpose of such filing was to apprise the trustee of outstanding claims against the bankruptcy estate, the government was entitled to rely on the claims filed by the employees.

3. We disagree with the holding of the court of appeals that the government's claim for withholding taxes is entitled to second, rather than first, priority status under Section 64(a) of the Bankruptcy Act. In our view, the withholding taxes here constitute expenses of administration entitled to a first priority under Section 64(a)(1) of the Act. See *United States* v. *Fogarty, supra; Lines* v. *California Department of Employment, supra.* The court below rejected this contention on the grounds that withholding taxes do not "relate to the preservation or development of the bankrupt's assets" (Pet. App. A, p. 9a) and that it would be anomalous to accord such taxes a higher priority than the wage claims themselves. The court erred on both grounds.

First, withholding taxes are simply a liability incurred by the trustee in the course of distributing the assets of the estate; like other costs of distributing assets—for example, the salaries of clerical assistants and mailing costs—withholding taxes are a legitimate expense of administering the estate and are therefore entitled to a first priority under Section 64(a)(1) of the Act. Second, according withholding taxes a first priority creates no anomaly; those taxes arise only upon actual payment of the wages and so could never have priority over the wages themselves.

There is, in our view, more basis in the statute for thus treating withholding taxes on priority wage claims as first priority administrative expenses than there is for treating them as second priority items, as the court below has done.[7] The second priority under

[7]The importance to the government of a first rather than second priority derives from the fact that after the

Section 64(a)(2) of the Act covers only "wages and commissions." Although withholding taxes in a sense come out of wages, or at least are imposed on account of the payment of wages, that factor alone does not make them wages within the meaning of the statute. Cf. *Joint Industry Board* v. *United States,* 391 U.S. 224.

In any event, the Third Circuit in *Connecticut Motor Lines* erred in treating such withholding taxes as fourth priority items under Section 64(a)(4) of the Act. That priority covers only taxes which were "legally due and owing by the bankrupt" and, as we have shown above (pp. 5-6, *supra*), withholding taxes, such as the ones in issue here, that arise only after the adjudication of bankruptcy were never owed by the bankrupt.

Adoption by the court below of the Third Circuit's approach would have altered the distribution of assets to be made in the present case. For that reason, we believe that this case presents an appropriate occasion for resolution by this Court of the three-way conflict which has now arisen among the courts of appeals with respect to the proper priority to be accorded the government's claims for withholding taxes on priority wage distributions.

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distribution of wages, but before payment of the taxes, the estate may incur other administrative expenses which, if withholding taxes are not first priority items and were not segregated into a trust fund for the government (see *United States* v. *Randall,* 401 U.S. 513), would have priority over such taxes. In the present case, however, the assets in the estate appear adequate to satisfy the government's claim in full even under the second priority awarded by the court below.

CONCLUSION

For the foregoing reasons, we do not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

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JANUARY 1974.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the district court is reported at 341 F. Supp. 647 (70a). The opinion of the court of appeals is reported at 480 F. 2d 184 (5a).

Jurisdiction

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973 and was granted on January 21, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Statutes and Authorities Involved

(See Appendix)

Title 11, United States Code:

§ 67a(5)
§ 75a(4)
§ 93a
§ 93j
§ 93n
§ 103(a)(8)
§ 104(a)(1)
§ 104(a)(2)
§ 104(a)(4)
§ 104(a)(5)

Internal Revenue Code, Title 26, United States Code:

§ 3102(a)
§ 3401(a)
§ 3401(d)(1)
§ 3402(a)
§ 6001
§ 6011
§ 6672

Questions Presented For Review

1. Does a distribution in a bankruptcy proceeding pursuant to 11 U.S.C. § 104(a)(2) constitute "wages" which are subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code

2. Assuming *arguendo* that such a distribution is subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the claims of the United

States and New York City have been barred because no proofs of claim for the taxes in issue were filed by them in the Bankruptcy Court?

3. Assuming *arguendo* that such a distribution is subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code, should the monies withheld in connection with the distribution be accorded "priority" status pursuant to 11 U.S.C. § 104(a)(2) and (4), "administrative claim" status pursuant to 11 U.S.C. § 104(a)(1), "trust fund" status, or unenforceable "penalty" status?

4. Is compliance with the withholding and reporting requirements of the Internal Revenue Code and the New York City Administrative Code in connection with such a distribution inconsistent with the spirit of economy of the Bankruptcy Act and therefore inapplicable in bankruptcy proceedings?

Statement of the Case

Freedomland, Inc. ("Freedomland") filed a petition for an arrangement under Chapter XI of the Bankruptcy Act in the United States District Court, Southern District of New York on September 15, 1964 (18a). On August 30, 1965, it was adjudicated a bankrupt (18a).

During the statutory filing period for filing claims, 413 claims of $600.00 or less were filed by Freedomland's former employees in its bankruptcy proceeding on account of wages that had been earned by the claimants *prior* to September 15, 1964, the date on which Freedomland filed its Chapter XI petition (30a, 32a). No proofs of claims for withholding, social security, or related payroll taxes relative to these claims were filed by the United States or the City of New York during the statutory filing period, after the expiration of that period, or pursuant to the "bar order" en-

tered in the bankruptcy proceedings which directed all taxing authorities having claims against Freedomland or its Trustee to file their claims with the Trustee's attorney or be "forever barred from making any claim against Freedomland's estate or the Trustee" [Petitioner] (71a).

Freedomland's bankruptcy schedules indicated that it owed $80,000.00 on account of priority wage claims. However, the schedules omitted to set forth the names, addresses, social security numbers. number of dependents or related information concerning the claimants to whom such amount was admittedly due (23a) although it is possible that such information existed in forty-two filing cabinets of Freedomland's records located at a warehouse (54a).

On November 7, 1969, Petitioner moved for an order directing distribution to Freedomland's 413 priority wage claimants without any requirement to: (1) withhold Federal, State or City taxes, (2) pay such taxes to the taxing authorities, (3) file tax returns with the taxing authorities, (4) furnish withholding tax statements to the claimants, or (5) pay any penalties to the taxing authorities for failure to withhold and pay or file tax returns in connection with the distribution (18a, 26a). The order was granted on the ground, *inter alia,* that the withholding/reporting requirements of the taxing authorities were inconsistent with the object of efficient, expeditious, and economical administration of bankrupt estates (36a). Thereafter, on appeal to the District Court, and after an evidentiary hearing in which Petitioner presented evidence that compliance with the reporting and filing requirements of the taxing authorities would be burdensome and expensive (56a, 68a) and that a flat 25% deduction for United States taxes would exceed the amount of tax that would be deducted if official tax tables were used on known exemptions and past income (58a), the District Court concluded that Petitioner should be required to withhold United States but not New York City payroll related taxes in making wage claim distributions even

though the United States had failed to file a proof of claim for such taxes in the bankruptcy proceeding. The District Court also directed that such taxes as were withheld should be accorded "fourth priority" status under 11 U.S.C. § 104(a)(4), and that no tax need be withheld for New York City taxes because New York City's tax law did not become effective until 1966, after the date on which the wage claims accrued. (90a)

At the evidentiary hearing before the District Court, Petitioner presented evidence that in order to comply with what ultimately became the District Court's order, Petitioner would be required to, in addition to New York City tax reporting requirements where applicable, and in connection with the 413 priority wage claimants, assemble the required information from Freedomland's records and

a. Prepare and file Internal Revenue Service Form 941 on which Petitioner would have to report total wages which were subject to withholding, total amounts of taxes withheld, total wages which were subject to social security tax, each priority wage claimant's social security number, name and address, and the total of each claimant's withheld payroll and social security taxes. (See District Court Decision, at 77a, 78a) (57a, 58a);

b. Prepare and file Internal Revenue Service Form W-3 indicating withheld taxes for each quarter. (See District Court Decision, at 78a);

c. Prepare and file Internal Revenue Service Form W-2 for each priority wage claimant indicating federal income taxes withheld, wages paid subject to withholding in the year in question, state and city income taxes withheld, social security taxes withheld, the marital status of each claimant, and the social security number of each claimant. (See District Court Decision, at 79a) (60a).

Evidence was also presented that Petitioner and his accountant would be the subject of inquiry from each wage claimant as to the reason for the deductions (59a).

The District Court's opinion concluded that the preparation of the 941, W-2, and W-3 forms could be prepared by a clerk (See District Court Decision, at 80a) as opposed to an accountant and impliedly that such preparation would not be burdensome or expensive although, to prepare all of the returns, with the required information, the evidence established that 42 filing cabinets filled with records would have to be searched at Underwriters Salvage Company [official auctioneer of the Second Circuit] to locate the required information (56a), that these would have to be cross checked against the 413 proofs of claim on file with the Bankruptcy Court; that Petitioner would have to ascertain the social security numbers of and communicate with each wage claimant, determine their applicable tax exemptions, and thereafter determine Federal, State, and local taxes; that reconciliation schedules would then have to be prepared, summarized, cross referenced, cross footed, and transposed to Form 941; that the W-2 forms would have to be prepared; and that W-2 forms would then have to be furnished to each wage claimant and filed with the taxing authorities (57a, 63a to 66a).

On appeal to the United States Court of Appeals for the Second Circuit, the Circuit Court affirmed in part and reversed in part holding that taxes should be withheld for New York City as well as United States taxes, and that such taxes as were withheld should be accorded "second priority" "trust fund" status under 11 U.S.C. § 104(a)(2) (4a).

Summary of Argument

The Circuit Court held that distributions pursuant to 11 U.S.C. § 104(a)(2) constituted "wages" which were subject to the withholding tax, payroll tax, and reporting

requirements of the Internal Revenue Code and the New York City Code. Petitioner contends that such distributions are not wages, that he is in no sense an employer of priority wage claim distributees, that they are in no sense his employees, and therefore that the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code are inapplicable to priority wage claim distributions. Petitioner further contends that even if this court were to hold that the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code were applicable to priority wage claim distributions, that the monies which he would be required to withhold (1) should not be accorded "priority" claim status pursuant to 11 U.S.C. § 104(a)(2) and (4) because that status applies only to wages and taxes owed by a bankrupt, not to withheld taxes or to taxes which become due after bankruptcy, (2) should not be accorded "administrative claim" status because the taxes in issue do not relate to the preservation or development of the bankrupt's estate, (3) should not be accorded "trust fund" status because this court has ruled that it cannot, and (4) should not be turned over to the taxing authorities because to do so would violate 11 U.S.C. § 93j which proscribes the enforcement of penalties. In any event, Petitioner contends that regardless of the applicability of the withholding tax, payroll tax and reporting requirements to priority wage claim distributions in this proceeding the United States and the City of New York could have filed proofs of claim for such taxes within the applicable filing periods but failed to do so and therefore, that their claims are totally barred. Finally, Petitioner contends that compliance with the withholding tax, payroll tax and reporting requirements of the Internal Revenue Code and the New York City Administrative Code are contrary to the spirit of economy of the Bankruptcy Act and unenforceable against a bankruptcy trustee in the absence of a clear Congressional direction requiring compliance.

POINT I

Distributions in bankruptcy proceedings pursuant to 11 U.S.C. § 104(a)(2) do not constitute "wages" which are subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code.

The Circuit Court held that the priority wage claim distributions pursuant to 11 U.S.C. § 104(a)(2) were "wages" which were subject to the withholding tax, payroll tax, and reporting requirements of the Internal Revenue Code and the New York City Administrative Code.* The Circuit Court erred.

When a Bankruptcy Judge declares a dividend pursuant to 11 U.S.C. § 104(a)(2), "wages", as defined in I.R.C. (26 U.S.C.) § 3401(a) are not involved. This follows from I.R.C. (26 U.S.C.) § 3401(a) and 26 C.F.R. § 31.3401(c)-1 (a) and (b) which define 'wages" and the employer-employee relationship which is a condition precedent to the characterization of remuneration as "wages" in terms of a *current* performance of services involving an existing "control" relationship of "employer" over "employee." Neither aspect exists in the bankruptcy trustee-wage claimant relationship. See I.R.C. (26 U.S.C.) § 3401(a) which defines "wages" as a "remuneration * * * for services performed by an employee for his employer * * *," 26 C.F.R. § 31.3401(c)-1(a) which defines the term "employee" to include "every individual performing services", and 26 C.F.R. § 31.3401(c)-1(b) which states that "Generally, the relationship of employer and employee exists when the person

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* The New York Administrative Code incorporates the Internal Revenue Code by reference. Accordingly, the analysis which follows is equally applicable to the New York City Administrative Code.

for whom services are performed has the right to control and direct the individual who performs the services * * * ". See also Rev. Rul. 69-136, 1961-1 Int. Rev. Bull., Jan.-June, 252, 253, in which the Internal Revenue Service ruled that payments made after "the employment relationship between the employees and the * * * company * * * was terminated" were not "wages" for withholding, social security, or unemployment tax purposes, and Rev. Rul. 55-520, 1955-2, Int. Rev. Bull. July-Dec. at 393, 394, in which the Internal Revenue Service reached a similar result.

In arriving at its decision that wage claim distributions constituted "wages" for withholding and payroll tax purposes the Circuit Court held that bankruptcy trustees were "employers" under I.R.C. (26 U.S.C.) § 3401(d)(1). It had to reach this conclusion for under the Internal Revenue Code a "wage" cannot exist in the absence of an "employer." Thus, the Circuit Court concluded that bankruptcy trustees were "employers" because they are "the persons having control of the *payment* of * * * wages" inasmuch as "the trustee applies for the order [of wage claim dividend distribution] and has title to the funds to be paid and * * * he sends the checks out * * * " (10a, ft. n. 4).

Contrary to the Circuit Court's holding, it is the Bankruptcy Judge alone who has the duty to declare wage claim and other dividends whether or not they have been applied for by a bankruptcy trustee. Moreover, and more frequently than not, it is the Bankruptcy Court itself, and not bankruptcy trustees, who send out dividend checks. See 11 U.S.C. §§ 67a.(5) and 75a.(11). See also Rule 308, Rules of Bankruptcy Procedure. *Matter of Stringer*, 244 F. 629, (E.D. N.Y., 1917), *Matter of Prindible*, 115 F.2d 21 (3rd Cir. 1940), and 3A *Collier on Bankruptcy*, 2289, § 65.05 (14th ed. 1940). Under the Circuit Court's own reasoning then, and since "control," not "title" is the test, a bankruptcy trustee could not be an "employer" and not being such, no wage claim distribution that might be made can

rise to the stature of a "wage" for withholding tax, payroll tax, or related purposes.

Notwithstanding some doubts on the subject, the Circuit Court felt constrained to hold that wage claim distributions were "wages" for withholding tax and related purposes, in reliance on *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. denied,* 339 U.S. 965 (1950), *Lines* v. *State of California,* 242 F.2d 201 (9th Cir. 1957), *cert. denied,* 355 U.S. 857 (1957), and *In Re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir. 1964). The court's reliance was misplaced.

The *Lines* decision does not deal with Federal taxes, and in any event relies on the *Fogarty* decision, as does *Curtis,* on the questions at issue. *Connecticut Motor Lines* did not even consider the issue. Thus, we are relegated to the *Fogarty* decision which, it is submitted, was in error because it incorporates this Court's definition of "wages" in a social security tax context in reliance on *Social Security Board* v. *Nierotko,* 327 U.S. 358 (1946) notwithstanding that the *Nierotko* case had no Bankruptcy Act overtones. Significantly, in *United States* v. *Embassy Restaurant,* 359 U.S. 29 (1958), when this Court was called upon to define "wages" in a Bankruptcy Act context, it reached a result that was diametrically opposed to the *Nierotko* decision because the Bankruptcy Act was involved. It is for this reason that *Educational Fund of the Electrical Industry* v. *United States,* 426 F.2d 1053, (2d Cir. 1970) referred to in the Circuit Court's decision is also irrelevant to the decision in the case at bar. See *Embassy Restaurant, supra,* in which this Court held:

> "[W]e deal with a statute, not business practice. Nor do we believe that holdings * * * under the NLRA or the Social Security Act are apposite. We construe the priority section of the Bankruptcy Act, not those statutes" (at p. 33).

Since wage claim distributions are not "wages", it follows that they are not the subject of the reporting requirements of the Internal Revenue Code. See I.R.C. (26 U.S.C.) §§ 6001 and 6011.

POINT II

The claims of the United States and New York City are barred because proofs of claim for the taxes at issue were not filed with the bankruptcy court.

The United States and New York City failed to file proofs of claim for the taxes at issue (71a). They failed to file their claims, notwithstanding the following: (1) they were at all times on notice from Freedomland's bankruptcy schedules that Freedomland owed approximately $80,000.00 on account of priority wage claims (23a); (2) they were on notice that under the provisions of 11 U.S.C. § 93n priority wage claimants had a six-month period after Freedomland's first meeting of creditors following its adjudication as a bankrupt in which to file their claims or be forever barred from doing so; (3) they were able to compute the total maximum amount of taxes that would be involved following the expiration of the aforesaid six-month bar period, and could file their claims by obtaining an extension of time in which to compute and file their claims pursuant to 11 U.S.C. § 93 n.

Despite the ability of the United States and the City of New York to file claims, the Circuit Court held that

> "Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt,* * * * The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholding due by law" (16a).

The Circuit Court erred.

Because of the time bar and extension of time provisions of 11 U.S.C. § 93, it was not impossible for the United States and New York City to file proofs of claim on the total maximum amount of taxes they might be entitled to, with their claims being subject to reduction in the event the wage claims themselves were reduced or disallowed. In addition, if a bankruptcy trustee is in fact obligated to withhold tax and pay payroll related taxes on wage claim distributions, such would constitute a "contingent" and therefore provable debt for which the United States and New York City could and should have filed proofs of claim for their claims to be allowed. See 11 U.S.C. § 103(a)(8) which provides that contingent debts are "provable." Moreover, the concept of a constructively filed proof of claim finds no expression in the Bankruptcy Act. On the contrary, the Bankruptcy Act specifically provides that a proof of claim must be signed and in writing, 11 U.S.C. § 93a., and that "all claims provable under [the Bankruptcy Act], including all claims of the United States and of any state or any subdivision thereof" must be proved and filed as provided for in the Bankruptcy Act or be disallowed. See 11 U.S.C. § 93n., *In Re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), and *In Re Erie Forge & Steel Corp.*, U.S.D.C., Western District of Pennsylvania, No. 69-83 December 29, 1962 (unreported). See also Rule 302(a), Rules of Bankruptcy Procedure, adopted well after Freedomland's adjudication as a bankrupt but nevertheless according to the Advisory Committee's note, a substantial restatement of 11 U.S.C. § 93a. This rule specifically says that every creditor, including the United States, must file proofs of claim for its claim to be allowed. Finally, the Circuit Court simply ignored the Bankruptcy Judge's "bar order" which provided, *inter alia*, that all taxing authorities having claims against Freedomland's estate or the Trustee arising subsequent to the date on which Freedomland filed its Chap-

ter XI petition were directed to file claims or forever be barred from making any claims against Freedomland's estate or its Trustee (24a, 25a).

The Circuit Court's holding was also in error as a matter of policy because it opens up an avenue to other creditors who might claim a "constructive" claim position, thereby subjecting bankruptcy estates to contingencies that would make the administration of a bankruptcy proceeding extremely difficult.

POINT III

If Freedomland's trustee is directed to withhold taxes in connection with wage claim distributions, such taxes should not be accorded "priority", "administration claim", or "trust fund" status, and should be deemed an unenforceable "penalty".

The Circuit Court held that taxes withheld by Freedomland's Trustee in connection with wage claim distributions were entitled to "second priority" "trust fund" status under 11 U.S.C. § 104(a)(2), but not to "administration claim" status. The Circuit Court erred in according "second priority" "trust fund" status to the taxes in issue. It was correct, however, in holding that the taxes should not be accorded "administration claim" status.

A. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "priority" status.

1. Such taxes should not be accorded "second priority" status.

11 U.S.C. § 104(a)(2) accords "second priority" status to "wages and commissions, not to exceed $600 to each claimant * * *". No mention is made of taxes in this sub-

section although specific provision for taxes is made at subsections (a)(4) and (a)(5) of the statute, clearly indicating a Congressional intent *not* to include taxes in the "second priority" established by the statute.

The Circuit Court reasoned that withholding taxes to be derived from payments made to wage claimants constituted "wages" for the purpose of fitting within the "second priority" established by 11 U.S.C. § 104(a). The problem with this reasoning is that it ignores the decision of this Court in *United States* v. *Embassy Restaurant*, 359 U.S. 29 (1958). In the *Embassy Restaurant* case this Court held that the priority sections of the Bankruptcy Act were to be interpreted without reference to other statutes; that payment to a third party on behalf of a wage claimant by a bankruptcy trustee would not constitute part of a wage claimant's "wage" within the scope of the second priority of 11 U.S.C. § 104(a); that to be a "wage" a payment must have the common attribute of a "wage"; and finally, unless "it is clear that [the payments] satisfy the purpose for which Congress established the priority * * * [viz.] to provide the workman a 'protective cushion' against the economic displacement caused by his employer's bankruptcy" (at p. 33) the payments could not constitute 'wages' within the scope of the "second priority." In explaining the policy behind the "wage claim" priority, this Court also held that

> "[T]he purpose of Congress has constantly been to enable employees displaced by bankruptcy to secure, with some promptness, the money directly due them in back wages, and thus to alleviate in some degree the hardship that unemployment usually brings to workers and their families" (at p. 32),

and it reached the conclusion that

> "It is therefore evident that not all types of obligations due employees from their employers are recorded

> by Congress as being in the concept of wages, even though having some relation to employment." (at p. 32)

See also *Joint Industry Board* v. *United States*, 391 U.S. 224, (1968)

In view of this Court's decision in the *Embassy Restaurant* case, it is difficult to see how the Circuit Court could conclude that withholding taxes were the equivalent of wages. The Bankruptcy Act does not view the two as equivalent; taxes certainly do not have the common attributes of wages; and most significantly, by reducing the amount of money made immediately available to all workmen, viewing the two as equivalent cannot enhance the protective cushion that Congress sought to establish. Moreover, to be consistent, the Circuit Court would also have to have concluded that taxes withheld in connection with pre-bankruptcy wage payments but not turned over to the taxing authorities, also constituted wages, a result which would be directly contrary to 11 U.S.C. § 104(a)(4) which establishes a "fourth priority" for unpaid taxes.

2. Such taxes should not be accorded "fourth priority" status.

11 U.S.C. § 104(a)(4) accords fourth priority status to

> "taxes which became legally due and owing by the bankrupt to the United States or to any State or subdivision thereof * * *"

Taxes withheld by a bankruptcy trustee in connection with wage claim distributions do not constitute "taxes which became legally due and owing by the bankrupt" or at the date of bankruptcy. By virtue of I.R.C. (26 U.S.C.) § 3402(a), such taxes can only be withheld when payment of "wages" is made. Accordingly, when a wage claim distribution is being made, it follows that the bankrupt owed, but

had not paid wages, and withholding taxes were not and could not have been due and owing by the bankrupt or at the date of bankruptcy, although a contingent tax indebtedness may have existed on the date of bankruptcy. See also 26 C.F.R. § 31.3402(a)-1(b) which provides that

> "The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages *as and when paid* * * *" (emphasis supplied).

and the similar requirement imposed by N.Y. Admin. Code § T46-12.0.

Further evidence that no priority status should be accorded the claims of the United States and the City of New York is found in the 1966 amendments to 11 U.S.C. § 104(a)(4) which added among other things the words "which became" between the words "taxes" and "legally due and owing" so that the revised section accords priority status to

> "taxes *which became* legally due and owing by the bankrupt * * * which are not released by a discharge in bankruptcy; *Provided, however,* that no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority * * *" (emphasis supplied).

Thus, taxes arising *after* bankruptcy, not being included in the fourth priority, must be relegated to general unsecured claim status. As explained in House Report No. 687, 89th Congress, 1st Session

> "The committee believes that limiting tax priority to those taxes which became due and owing within three years *preceding* bankruptcy adequately safeguards the public interest in the collection of revenues * * *" (emphasis supplied).

B. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "administration claim" status.

The Circuit Court was correct in rejecting the holding in *United States* v. *Fogarty*, 164 F.2d 26 (8th Cir. 1947) insofar as that decision held that taxes withheld by a bankruptcy trustee should be allowed and classified as an expense of administration. Almost every other decision with the exception of *Fogarty* and *Lines* v. *State of California*, 242 F.2d 201 (9th Cir. 1957), *cert. den.*, 355 U.S. 857 (1957), has held in analogous situations, directly and by implication, that taxes withheld by a bankruptcy trustee in the distribution of wage claims cannot constitute an administration expense under the Bankruptcy Act. See *In Re John Horne*, 220 F.2d 33 (7th Cir. 1955); *Pomper* v. *United States*, 196 F.2d 211 (2d Cir. 1952); *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3d Cir. 1964).

The reason why taxes withheld in connection with wage claim distributions cannot constitute an administration expense under the Bankruptcy Act is that an expense accruing during bankruptcy is a cost of administration only if it relates to the preservation or development of the bankrupt's assets. See *e.g.*, *Edair* v. *Bank of America Assn.*, 303 U.S. 350 (1938). Thus, non-tax expenses such as rent accruing after a bankruptcy petition is filed and taxes incurred by a debtor-in-possession can be accorded administration claim status. On the other hand, a tax which becomes due after bankruptcy does not automatically entitle it to first priority status when the activity giving rise to the taxes took place before bankruptcy and had no connection with the development or preservation of the bankruptcy estate. See, *e.g. Philadelphia & Reading Coal & Iron Co.* v. *Van Deusen*, 103 F.2d 869 (3rd Cir. 1939) *cert. den. sub nom. Olley* v. *Philadelphia & Reading Coal & Iron Co.*, 308 U.S. 560 (1939). Nor can they be said to be costs of distributing assets since they are income taxes imposed on the

employees rather than taxes imposed on the act of distribution. Moreover, it is illogical to give employees' taxes a higher priority than "second priority" wage claims which determine the amount of taxes. And, where an estate is insufficient to pay any part of the second priority claims, first priority status for the taxes would be meaningless because no taxes would be due until the wages were actually paid See I.R.C. (26 U.S.C.) § 3402(a).

C. Taxes withheld by Freedomland's trustee in connection with wage claim distributions should not be accorded "trust fund" status.

The Circuit Court held that the taxes in issue were to be accorded second priority "trust fund" status, presumably avoiding thereby this Court's decision in *United States* v. *Randall,* 401 U.S. 513 (1971). As indicated above, the Circuit Court erred in according the taxes in issue second priority status, and finding that the wage claim distributions involved were taxable. It is submitted that in creating a trust it erred again, and that "trust fund" status runs directly contrary to this Court's holding in *Randall* in which this Court said:

> "We think the statutory policy of subordinating taxes to costs and expenses of administration would not be served by creating or enforcing trusts which eat up an estate, leaving little or nothing for creditors and court officers whose goods and services created the assets" (at p. 517).
>
> * * *
>
> To allow [trust fund claim] would * * * run counter to the grain of the Bankruptcy Act" (at p. 517).

See also *Nicholas* v. *United States,* 384 U.S. 687 (1966).

The Circuit Court's decision also creates an anomaly in its attempt to distinguish the *Randall* decision. *Randall*

held that where wage claims were actually paid during a Chapter XI proceeding as an administration expense, the tax which should have been withheld did not fall into the same priority status under the Bankruptcy Act as the wage claim itself; whereas the Circuit Court held that where the wage claims have not been paid, that they do.

D. The imposition of a withholding tax requirement upon Freedomland's trustee would constitute the imposition of a penalty which could not be enforced under the Bankruptcy Act.

I.R.C. (26 U.S.C.) § 6672 provides that any "employer" who fails to collect withholding taxes or pay it over to the government in connection with the payment of "wages" will

> "* * * be liable to a *penalty* equal to the total amount of the tax * * * not collected, * * * and paid over" (emphasis supplied).

See also N.Y.C. Admin. Code § U46-35.0(g). 11 U.S.C. § 93j disallows

> "Debts owing to the United States or to any state or any subdivision thereof *as a penalty* * * * except for the pecuniary loss sustained by the act * * *" (emphasis supplied).

In the event Freedomland's Trustee were to make a wage claim distribution without withholding taxes, he would be subjected to a penalty claim for the amount of withholding taxes he failed to collect. Inasmuch as the United States and the City of New York could collect the non-withheld taxes due them directly from the wage claimants involved they would not sustain any pecuniary loss by virtue of the Trustee's non-collection of withholding taxes. Therefore, they would fail to come within the exception of 11 U.S.C. § 93j and their claims would be barred as being equivalent to a "penalty."

POINT IV

The Bankruptcy Court's ruling that "compliance with withholding and reporting requirements of the taxing authorities is utterly inconsistent with the spirit and letter of the Bankruptcy Act" was not clearly erroneous and should *not* have been reversed.

The Bankruptcy Court held that

> "To apply the *Fogarty Rule* [that a trustee must make withholding tax deductions on wage claims distributions] in every bankruptcy case would impose a further burden on the administration of those estates which is entirely inconsistent with the object of efficient, expedient and economic administration of bankrupt estates" (36a).

The Bankruptcy Court further held that

> " * * * compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and the letter of the Bankruptcy Act" (37a).

The Bankruptcy Court's holdings, based on the facts of the instant case, the Bankruptcy Referee's knowledge of the extensive bankruptcy records on file in this proceeding, his intimate knowledge of and expertise in bankruptcy matters, and his adoption by implication of Referee Hiller's factual conclusion in a law review article appended to the Bankruptcy Court's decision, *inter alia,* that "trustees usually have no training in payroll accounting and need accounting services, whose cost is borne by unsecured creditors", was not clearly erroneous. Therefore, the Bankruptcy Court's decision should not have been reversed. See General Orders in Bankruptcy, No. 47. Compare Rule 810, Rules of Bankruptcy Procedure. In fact, the Bank-

ruptcy Court's findings were substantiated at the evidentiary hearing conducted by the District Court.

The Bankruptcy Court's findings must be interpreted in light of the historic development of the Bankruptcy Act which demonstrates an overriding concern with the necessity for reducing administration expenses. See 3A *Collier On Bankruptcy* 1429, § 62.05 (1) and 1396, § 62.02 (1) (14th ed. 1940). Therefore, as held by the Bankruptcy Court, a requirement that Freedomland's Trustee withhold taxes on wage claim distributions and prepare tax and related returns and reports would involve an expense having no benefit to creditors as a whole, and would violate the "spirit of economy" of the Bankruptcy Act. Accordingly, the Bankruptcy Court ruled that in the absence of a clear Congressional direction to the contrary, a bankruptcy trustee should not be required to perform such a function. Compare *In Re Berneddy's, Inc.*, 108 F. Supp. 183 (D.C. Mass., 1952), *aff'd sub nom. Commonwealth of Massachusetts* v. *Widett*, 204 F.2d 512 (1st Cir. 1953) in which a Bankruptcy Trustee was exempted from preparing state employment reports on grounds of "economy."

The District Court's decision amply illustrates the burdens that the Bankruptcy Referee referred to in the application of the *Fogarty Rule*. It readily admitted that the *Fogarty Rule* would require the Trustee to prepare all of the federal and city computations, forms and documents referred to earlier in this brief in connection with the 413 wage claimants involved in this proceeding.

The District Court concluded, and the Circuit Court concurred, that the computations and forms could be prepared, by a clerk (See District Court Decision, at 80a), as opposed to an accountant and therefore that such preparation would not be burdensome. The facts, discussed elsewhere in this brief, conclusively demonstrate otherwise. See pp. 4 and 5, *supra*.

One of the reasons why the District and Circuit Courts ruled that preparing the forms was not burdensome was the existence of a "25% rule", *i.e.* a rule that 25%, or in the case of New York City taxes, 1%, is automatically deducted in lieu of using wage claim tables, thus simplifying computations. The District Court called this a rule, but no evidence exists in the record that such a rule exists, or that any basis in law or regulation exists for applying such a rule.

Petitioner submits that compliance with the withholding tax, payroll tax and reporting requirements of the Internal Revenue Code and New York City Administrative Code are in fact burdensome and expensive. Were this not a bankruptcy proceeding, the burden and expense would be irrelevant to petitioner's legal obligations. But the fact is that this is a bankruptcy proceeding and the requirements of the Internal Revenue Code and the New York City Administrative Code must be viewed in that light. The policy and letter of the Bankruptcy Act require that bankruptcy proceedings be administered economically and expeditiously, especially in a case such as this where the United States and the City of New York can collect their just due from the wage claimants themselves without imposing a costly burden on Freedomland's estate. No substantial reason exists why all of the other creditors of Freedomland's estate should have to subsidize the United States and the City of New York in their tax collection endeavors, which in any event are of little benefit to the taxing authorities involved. For as stated in the Brookings Institution's report on bankruptcy, Stanley & Girth, *Bankruptcy, Problem, Process, Reform*, 131 (Brookings Institution, 1971):

> "[T]he point is clear: The federal tax priority has a miniscule effect on federal revenues but a major effect on dividends paid to unsecured creditors in bankruptcy cases. Repeal of such priority is recommended * * *.

CONCLUSION

The Circuit Court's order should be reversed and the Bankruptcy Court's order should be reinstated.

Respectfully submitted,

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Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

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Petitioner,

v.

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

Respondents.

BRIEF OF RESPONDENT, THE CITY OF NEW YORK

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UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

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BRIEF OF RESPONDENT, THE CITY OF NEW YORK

Statement

On petition of the Trustee in Bankruptcy of Freedomland, Inc., this Court granted a writ of certiorari (100a)* to the United States Court of Appeals for the Second Circuit. The decision of that Court, which is under review, held:

1. That a trustee in bankruptcy on payment of wage claims entitled to priority under subdivision 2 of Section 64a of the Bankruptcy Act (11 U.S.C. § 104), is required to withhold from payment, federal withholding taxes pursuant to Sections 3402 (income tax) and 3102

* Unless otherwise indicated, references in parentheses are to pages of the Appendix.

(tax on employees, Federal Insurance Contributions Act) of the Internal Revenue Code as well as amounts required to be withheld pursuant to the Administrative Code of the City of New York, Sections T46-51.0 (City personal income tax on residents) and U46-8.0 (earnings tax on nonresidents);

2. That the trustee is also required to prepare and file with the taxing authorities the requisite returns and forms with a report of the withholding taxes;

3. That the claims for withholding taxes against the bankrupt estate were entitled to second priority wage claim status; and

4. That proofs of claim other than those filed by the wage claimants were not necessary for the withholding taxes involved.

Reported below: 480 F. 2d 184 (1973); 341 F. Supp. 647 (1972).

Statutes Involved

The federal withholding tax on wages is governed by Chapter 24 of the Internal Revenue Code (26 U.S.C. §§ 3401 to 3404). Subsection (a) of Section 3401 defines "wages" as follows:

> "For purposes of this chapter, the term 'wages' means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash;"

Paragraph (1) of subsection (d) of that Section which defines "employer", provides that:

> "[I]f the person for whom the individual performs or performed the services does not have control of the

payment of the wages for such services, the term 'employer' (except for purposes of subsection (a)) means the person having control of the payment of such wages,"

The tax is imposed by Section 3402 of the Internal Revenue Code, subsection (a) of which reads in pertinent part as follows:

"Requirement of Withholding.—Every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables. For purposes of applying such tables, the term 'the amount of wages' means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table in subsection (b)(1):"

The federal withholding tax relating to social security (FICA) is governed by Internal Revenue Code Chapter 21 (Federal Insurance Contributions Act). Section 3101 of that Code imposes the tax and presently reads, in pertinent part, as follows:

"(a) Old-Age, Survivors, and Disability Insurance. —In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—*

* * * *

---

* The percentages which follow here vary greatly between the year 1964, when the wages in question were earned, and the present time. There is also a variance in income tax withholding rates within that period as well as in New York City tax rates.

(b) Hospital Insurance.—In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))—"*

Section 3102 of that Code, subsection (a), reads, so far as pertinent, as follows:

"The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid."

Section 3121(a) of that Code defines wages as "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash;"

Subsection (a) of Section 31 of the Internal Revenue Code reads as follows:

"(a) Wage withholding for income tax purposes.—

(1) In General.—The amount withheld under section 3402 as tax on the wages of any individual shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle.

(2) Year of credit.—The amount so withheld during any calendar year shall be allowed as a credit for the taxable year beginning in such calendar year. If more than one taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning."

Subsection (a) of § 7501 of that Code reads as follows:

"Whenever any person is required to collect or withhold any internal revenue tax from any other

* This additional tax was not in force when the wages were earned in 1964. It became effective in 1968 and its rates increased in 1973 with further increases for later years.

person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

The withholding tax requirement of the New York City personal income tax on residents (Title T of Chapter 46 of the Administrative Code of the City of New York) is set forth in subdivision (a) of § T46-51.0 of that Code and reads, so far as pertinent, as follows:

"On or after the first payroll period beginning forty-five days after the date this title becomes effective, every employer maintaining an office or transacting business within this state and making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due under this title resulting from the inclusion in the employee's city adjusted gross income of his wages received during such calendar year. The method of determining the amount to be withheld shall be prescribed by regulations of the administrator with due regard to the city withholding exemptions of the employee and the sum of any credits allowable against his tax. This section shall not apply to payments by the United States for service in the armed forces of the United States."

A similar withholding provision for the New York City earnings tax on nonresidents, Title U of the Administra-

tive Code, is contained in § U46-8.0 and reads as follows:

> "On or after the first payroll period beginning forty-five days after the date this title becomes effective every employer maintaining an office or transacting business within this state and making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax computed in such manner as to result, so far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the tax reasonably estimated to be due from the employee under this title. The method of determining the amount to be withheld shall be prescribed by regulations of the administrator."

New York City Administrative Code § T46-53.0 provides as follows for the income tax on residents:

> "Wages upon which tax is required to be withheld shall be taxable under this title as if no withholding were required, but any amount of tax actually deducted and withheld under this title in any calendar year shall be deemed to have been paid to the administrator on behalf of the person from whom withheld, and such person shall be credited with having paid that amount of tax for the taxable year beginning in such calendar year."

Similar provisions relating to the earnings tax on nonresidents are found in § U46-10.0 of that Code and read as follows:

> "Wages upon which tax is required to be withheld shall be taxable under this title as if no withholding were required, but any amount of tax actually deducted and withheld under this title in any calendar year shall be deemed to have been paid on behalf of

the employee from whom withheld, and such employee shall be credited with having paid that amount of tax in such calendar year. For a taxable year of less than twelve months, the credit shall be made under regulations of the administrator."

Section T46-55.0 (income tax) and § U46-12.0 (earnings tax) of the Administrative Code both provide that:

"* * * Any amount of tax actually deducted and withheld under this title shall be held to be a special fund in trust for the city."

Section T46-1.0(c) of the New York City Administrative Code provides that:

"Unless a different meaning is clearly required, any term used in this title shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, and any reference in this title to the internal revenue code, the internal revenue code of nineteen hundred fifty-four or to the laws of the United States shall mean the provisions of the internal revenue code of nineteen hundred fifty-four, and amendments thereto, and other provisions of the laws of the United States relating to federal income taxes, as the same are included in the appendix to this title."

The analogous provision in the City earnings tax on non-residents is contained in subdivision b of § U46-1.0 of the Administrative Code and reads as follows:

"'Payroll period' and 'employer' mean the same as payroll period and employer as defined in subsections (b) and (d) of section thirty-four hundred one of the internal revenue code of nineteen hundred fifty-four * * *."

The following portions of § 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) are involved:

"Sec. 64a.—The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be

(1) The costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupts in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of the recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of title 18 of the United States Code, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of

accountants and appraisers employed by them, in such amount as the court may allow. Where an order is entered in a proceeding under any chapter of this Act directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by sections 238, 378, or 483, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any;

(2) Wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term 'traveling or city salesman' shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract;

* * * *

(4) Taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court;"

Questions Presented for Review

This case raises the following questions:

1. Is a trustee in bankruptcy, when he pays pre-bankruptcy wage claims, required to withhold, report and pay withholding taxes under Internal Revenue Code (26 U.S.C.) § 3401 (income tax) and § 3101 (FICA), and the New York City counterparts of the income tax provisions, Administrative Code § T46-51.0 (income tax on residents) and § U46-8.0 (earnings tax on nonresidents)?

2 If so, do these withholding taxes enjoy priority status as wage claims under Bankruptcy Act § 64a(2), tax claim status under subdivision (4) of that section, or administration expense status under subdivision 1 of that section?

3. Is it necessary for the taxing authorities to have filed proofs of their claims for these withholding taxes within the period provided in Bankruptcy Act § 57n when the taxes do not become due and their amounts cannot be ascertained until the wage claims are actually paid?

Statement of the Case

The bankrupt filed a petition for an arrangement on September 15, 1964 and was adjudicated a bankrupt on August 30, 1965 (6a).

Four hundred and thirteen former employees of the bankrupt filed timely claims for wages due them before the petition for arrangement (30a).

Neither the United States nor the City of New York filed proofs of claim for the withholding taxes which they claim will become due upon the payment of the wage claims (71a-72a).

On motion of the trustee, the referee in bankruptcy entered an order authorizing the trustee to pay the wage claims without withholding any federal income and social security taxes, any New York State or New York City withholding taxes for income tax or earnings tax or any other payroll taxes (48a-50a).

Petitions to review that order were filed by the United States of America and the City of New York. The United States District Court for the Southern District of New York reversed the order of the referee so far as it pertained to federal taxes, directed withholding of federal taxes but ordered that the amounts withheld be paid only as fourth priority tax claims under Bankruptcy Act § 64a(4) (92a). The Court denied the petition of the City of New York (*Ibid.*), thus denying it any withholding tax payments, on the ground that the New York City tax laws were enacted in 1966 and were not effective in 1964 when the wages in question became due (90a-91a).

The trustee, the United States and the City appealed from the District Court's order to the United States Court of Appeals (5a-6a), which affirmed in part and reversed in part the holding of the District Court (3a-4a), holding that a trustee must withhold, report and pay over the withholding taxes on the wage claims, that the United States and the City were entitled to be paid as second priority wage claimants under § 64a(2) and that the taxing authorities were not required to file proofs of claim because the filing of the wage claims constructively constituted a claim for that portion of the wage claims required to be withheld (5a-17a).

The Opinion Below

The opinion of the Court of Appeals first dealt with the question of whether moneys paid to wage claimants were wages within the Internal Revenue Code definition which also applied to the New York City taxes. It held

that, since that definition included all remuneration for services performed by an employee for his employer, it included amounts distributed to bankruptcy wage claimants. It also pointed out that the Internal Revenue Code definition of "employer" included the trustee as a person having control of the payment of wages. In drawing these conclusions, the Court followed the case of *United States* v. *Fogarty,* 164 F. 2d 26 (8th Cir., 1947), and pointed out that that case had been followed in the Third, Sixth and Ninth Circuits.

The Court next disposed of the trustee's complaint about excessive computations, employment of accountants, completion of forms and other work entailed in paying withholding taxes by pointing out that "[t]he trustee's and referee's parade of horribles * * * was quite deflated by the [District] court below in its findings * * *" to the effect that the work entailed could be handled by a payroll clerk, bookkeeper or other clerical employee and "adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment" (11a).

It next took up the question of priorities and concluded that the taxes in question could not be considered as administration expenses because then they would take priority over the wages on which they were based. Nor could the Court see classification as a fourth priority claim as taxes which became legally due and owing by the bankrupt because these taxes did not become due and owing and would not become due and owing until the wage claims were paid by the trustee and consequently were never due and owing by the bankrupt. It then concluded that, because the taxes in question were carved out of and deducted from the wage claims to which they related, and the wage claimants credited with the amounts withheld, conceptually the taxes should be treated in the same way as the wages from which they derived and of which they are a part. It then adverted to Internal Revenue Code

§ 7501 and its New York City analogues which provide for trust fund status for withheld taxes. It took the position that when wage claims are ordered to be paid, the withheld taxes should be segregated and held as trust funds. In stating this view, the Court did not imply that the segregated moneys had the kind of trust fund status which took precedence over administration expenses but rather viewed the trust which arises from the act of segregation as subject to the prior payment of costs and expenses of administration.

Finally, it expressed the hope that either Congress or this Court would resolve the conflict concerning priorities which existed among the different Circuits (17a).

Summary of Argument

I

The trustee in bankruptcy should be required to withhold federal income and social security taxes, as well as New York City income and earnings taxes, when he makes a distribution of wage claims. The wage claim payments are wages within the meaning of the federal and city statutes that require withholding from wages [I.R.C. (26 U.S.C.) Sections 3401(a) and 3121(a); Administrative Code of the City of New York, Sections T46-51.0(a) and U46-8.0]. While the trustee was not the employer of the wage claimants, for purposes of the taxes in question he is denominated an employer by subsection (d) of Section 3401 of the Internal Revenue Code, since he is "the person having control of the payment of such wages."

The fact that the payment of withholding taxes and the preparation of the various reports that accompany that payment may impose a burden and expense on the trustee and his estate does not justify freeing him from the obligations imposed by the various taxing laws. The addi-

tional work entailed was found, as a fact, to have been considerably less than that which was described by the trustee. But whether great or small, the work involved in the reporting and the paying of taxes required by law is an essential duty of the trustee.

II

The claims for withholding taxes will be satisfied by amounts carved out of and derived from the wages to which they relate. In a very real sense, they are not payments to the taxing authorities but payments to the wage claimants who are credited with their amounts by the taxing authorities. Indeed, they may ultimately be refunded to these wage claimants if other credits against their taxes equal or exceed those taxes. Because these withholding taxes are deducted from the wages of which they are a part, the taxes conceptually constitute wages. Accordingly, they are to be classified for purposes of determining priorities in distribution by the trustee, as wage claims, as the Court below properly held. They cannot be classified as tax claims because they were not taxes due and owing from the bankrupt. To consider them as administration expenses raises a problem in calculating the amount of moneys available for payment of wage claims. In order to determine that amount, administration claims must first be ascertained. But if the taxes are considered as expenses of administration, and cannot be calculated until the amount available for wage claims is determined, we are presented with a mathematical problem which is insoluble.

III

It was not necessary for the taxing authorities to file proofs of claim for these taxes. Indeed, it was not possible to file an accurate proof of claim because the extent of the taxes involved could not be determined until the actual payment of the wage claims. The taxes do not become due

until that payment is made and since the rates of tax change from time to time, the filing of a claim setting forth the maximum possible tax is not feasible. Indeed since there are no taxes due until the actual wage claim distribution is made, there is no claim until that time, which is long after the period for filing creditor's proofs of claims has expired.

Since the tax payments are actually payments of wages, the filing of the wage claims by the wage claimants for the full amount of wages to be paid, which claims included the amount of the taxes in question, was sufficient to constitute claims on behalf of the taxing governments. The fiilng of an estimated maximum tax claim would not be helpful in the administration of the estate, because the amounts of those tax claims were already included in the claims filed by the wage earners.

ARGUMENT

POINT I

A trustee in bankruptcy who makes a payment of wage claims is required to withhold and pay federal and New York City withholding taxes.

(1)

The Court below concluded that the trustee was obligated to withhold income and social security withholding taxes upon making payment of wage claims. In so holding the Court followed a line of precedents beginning with *United States* v. *Fogarty,* 164 F. 2d 26 (8th Cir., 1947). *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir., 1964); *United States* v. *Curtis,* 178 F.2d 268 (6th Cir., 1949), cert. den. 339 U.S. 965 (1950); *Lines* v. *State of California, Department of Employ.,* 242 F.2d 201 (9th Cir., 1957), rehearing den. with opinion 246 F.2d 70 (9th Cir., 1957) cert. den. 355 U.S. 857 (1957); *In re Daigle,* 111 F. Supp. 109

(D.C. Me., 1953). It pointed out that "[w]hile *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field, there is no decision of any court outstanding to the contrary on the point of necessity of withholding" (10a).

The theoretical underpinning of the holdings in this case and the *Fogarty* case is simple and sound. The courts held that wage claim payments are wages within the meaning of the federal statutes requiring withholding from wages. That is, they are "remuneration * * * for services performed by an employee for his employer" [I.R.C. (26 U.S.C.) § 3401(a)] and "remuneration for employment" [I.R.C. (26 U.S.C.) § 3121(a)].

While the services in question in *Fogarty* and those in question here were performed for the bankrupt and not for the trustee, they were nevertheless performed for an employer. When it came to liability for the tax which was laid upon the employer by the statute, the Court in *Fogarty* held that the trustee stood in the bankrupt employer's shoes. Moreover, as to the income withholding taxes, it held the trustee to be within the statutory definition of "employer" as did the Court below (10a). The tax law applicable in *Fogarty* provided, as does § 3401(d)(1) of the Internal Revenue Code, that "if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' * * * means the person having control of the payment of such wages * * *."

The same rationale applies to the City withholding taxes for they are imposed upon the payment of wages by an employer (Admin. Code §§ T46-51.0(a) and U46-8.0) and the terms "wages" and "employer" used in the City laws are deemed by those laws, to have the same meanings as those terms as defined in the Internal Revenue Code. Admin. Code, §§ T46-1.0(c) and U46-1.0(b) and (e). Consequently the same rule governs the question of the trustee's liability for both the federal and the City withholding taxes.

The taxes in question—as we shall show at greater length in Point II, *infra*,—do not become due and owing and are not payable until the wage claims are actually paid. Hence, they never were the bankrupt's obligation, even though the wages were. The taxes are the primary obligation of the person making payment of the wages or wage claims, in this case the trustee. He is the taxpayer and as trustee he is liable for the tax and is required to withhold its amount. See *Nicholas* v. *United States*, 384 U.S. 678, 692-693 (1966); *Boteler* v. *Ingels*, 308 U.S. 57 (1939). *Cf.* 28 U.S.C. § 959(b) and § 960.

(2)

The trustee, however, would have this Court free him from the duty of withholding, reporting and paying taxes on wage claim distributions in bankruptcy (Pet's Br., pp. 8-11). In the course of his argument, he urges a number of points upon this Court and cites various authorities in support of them. We shall discuss them briefly.

He cites two revenue rulings, Rev. Rul. 69-136, 1969-1, Int. Rev. Bull. 252, 253 and Rev. Rul. 55-520, 1955-2, Int. Rev. Bull., 393-394, in support of his position (Pet's br., p. 9). The rulings are inapposite, for the payments involved were not wages, *i.e.*, "remuneration • • • for services performed" [I.R.C. § 3401(a)]. The first did not even deal with employees but with former employees in military service who were given an amount to make up their loss of earnings while in service. The second dealt with an amount paid for cancellation of an employment contract.

While the bankrupt was the employer of the wage claimants and the trustee is not their employer, for purposes of liability for the tax involved the trustee is specifically denominated an employer by subsection (d) of § 3401 of the Internal Revenue Code as "the person having control of the payment of such wages." On this score, the trustee argues that he does not have such control because payment

requires an order of the bankrupicy court and the Court itself may send out the dividend checks (Pet's Br., pp. 9-10). But it is generally the trustee who applies for that order [as he did in this case (48a-50a)] and it is the trustee who must sign the checks which he submits for the Referee's countersignature and who, as trustee, has title to the funds to be paid. After the order is signed, he surely has control. That he may share control to a very limited extent with the Court and the Referee does not alter his status as an "employer."

The trustee criticizes *Fogarty* and its result because the Court in that case relied on *Social Security Board* v. *Nierotko*, 327 U.S. 358 (1946), and *Nierotko* "had no Bankruptcy Act overtones" (Pet's Br., p. 10). *Nierotko* held that back pay ordered by the National Labor Relations Board of a wrongfully discharged employee was "wages" entitling the employee to credit for old age benefits under the Social Security Act. We are unable to see why the absence of bankruptcy "overtones" makes the case inappropriate as a precedent supporting the decision in *Fogarty*. It dealt with an analogous and unconventional payment. Certainly it was not cited as the sole foundation for the decision.

The trustee then goes on to assert that this Court reached a conclusion "diametrically opposed" to *Nierotko* in the bankruptcy case of *U.S.* v. *Embassy Restaurant*, 359 U.S. 29 (1959). That case held that contributions due from an employer to a union welfare fund pursuant to a collective bargaining agreement were not wages entitled to wage claim priority under § 64a(2) [11 U.S.C. § 104(a)(2)] of the Bankruptcy Act. The *Nierotko* case and the *Embassy* case are not in opposition. The difference in result is not explained by the presence or absence of a bankruptcy setting. They were miles apart in factual content. In *Nierotko* the claimant was the employee and the subject was pay; in *Embassy* the claimant was a third party bene-

ficiary of a collective bargaining agreement, the subject of the claim was its right, not the employee's right, to payments from the bankrupt.

Nor is the trustee's attempt to demonstrate that *Educational Fund of Electrical Industry* v. *United States*, 426 F. 2d 1053 (2d Cir., 1970), is not relevant to the issue because it did not involve a bankruptcy, sound. The case was appropriately cited by the Court below (19a) to indicate the broad sweep of the provision of the Internal Revenue Code defining "employer" as one having control of the payment of wages.

(3)

The trustee espouses the view that the ruling of the Court below that withholding taxes should be paid by a trustee on pre-bankruptcy wages is unsound or, at least, unsound if applied to all bankruptcy cases (Pet's Br., pp. 20-22). It is argued that to require the trustee to withhold the taxes, pay them, and file and furnish the requisite returns and information forms would impose an excessive burden and expense on him and a diminution of the funds available for other creditors. He urges that this would be inconsistent with the letter and spirit of the Bankruptcy Act.

We can find nothing in the Bankruptcy Act which exempts the trustee from performing duties of administration required by statutes merely because there would be less expense and less work if he did not perform these duties. Nor do we think that the spirit of the Act alluded to applies, where economy is bought at the expense of tax claimants. Essentially this argument suggests that tax laws may place an onerous duty upon ordinary taxpayers, but, when those taxpayers happen to be trustees in bankruptcy, that duty should be remitted.

We think that the trustee has in mind the general rule of administrative economy applicable to fees and

allowances in bankruptcy [3A COLLIER ON BANKRUPTCY, pp. 1429-1430 (14th Ed., 1940); 1 REMINGTON ON BANKRUPTCY, pp. 58-61 (5th Ed., 1950)] and the need to preserve as much of the bankrupt estate as possible for creditors. This, however, does not mean that statutory duties may be avoided and that the rights of creditors may be disregarded.

Tax authorities are as much creditors as are general creditors; indeed they are creditors with a preferred status. The kind of economy sought here by the trustee would not benefit all classes of creditors, and it is that which should be the aim of economical administration. Moreover, were the trustee's view to prevail it would work injury to the wage claimants for their credits for old age benefits would be lessened by failure to pay the F.I.C.A. withholding taxes, a failure they could not make up by voluntary self-payment. See *United States* v. *Fogarty*, 164 F 2d 26, 29 (8th Cir., 1947).

The task of a trustee of a bankrupt estate is to administer that estate. True, he should do so as efficiently as possible. But, if in the course of administration, he comes upon an arduous task, it is nevertheless his duty to perform it. It may be that the work involved is more costly than the benefits to be derived by the beneficiaries of the undertaking. If this is his concern, he may, and should, seek amelioration by agreement or compromise with those beneficiaries. In the instant case, the United States government has offered to ease the trustee's task by permitting him to compute taxes at an estimated 25% (8a, 65a, 68a). The City made a similar gesture (90a), a gesture which it will adhere to despite the increase in rate of tax which occurred after the concession was made. (See *infra*, pp. 30-31)*

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* The trustee seems to complain of having his burden lightened in this manner (Pet's br., p. 22). If this is so, we have no objection to the use of actual rates.

We believe that, as a matter of law, the argument of excessive burden is wholly without merit and irrelevant. Nevertheless, the District Court took evidence on the question of administrative difficulty (77a) and concluded that the trustee's claims in this regard were considerably exaggerated (79a-81a).

In support of this argument the trustee (Pet's br., p. 21) cites 3A COLLIER ON BANKRUPTCY, pp. 1429, § 62.05(1) and 1396, § 62.02(1) (14th Ed., 1940). The citations are not in point. The subjects dealt with in the text are the general principles governing fees and allowances and their judicial control, and of course, here there are numerous cases dictating the "principle of economy" in those areas. *In re Berneddy's Inc.*, 108 F. Supp. 183 (D.C. Mass., 1952), aff'd *sub nom. Commonwealth of Massachusetts* v. *Widett*, 204 F.2d 512 (1st Cir., 1953), cited by the trustee (*ibid.*), is not analogous to our case. In that case, the Court refused to direct the trustee to prepare certain State employment reports. It stated, in effect, that it would be unfair and improper to eat up the few funds on hand to provide information which the State authorities could readily obtain by examining the bankrupt's books. But the important fact to be noted is that the Massachusetts law involved did not require the trustee to file the report in question. 108 F. Supp. at p. 184.

(4)

The trustee does not state whether the rule of economy for which he contends is a rule of general application or one applicable only where the burden of compliance with the tax law is in fact excessive. If not of general application, such a rule would require the resolution of factual questions in every case where wage claims were involved, the resolution of which would inevitably result in disharmonious decisions among the varying cases in which they were raised.

On the other hand, if the rule is to be one of general application so that, withholding taxes need never be paid by a trustee, it would mean that the tax would be excused in every case simply because in some cases payment and the accompanying duties might be onerous and expensive.

In the present case, the trustee points to the fact that he will have to prepare returns for $80,000 in priority wage claims, with names, addresses, social security numbers and withholding exemptions of the claimants, and that such information is contained somewhere in 42 filing cabinets located in a warehouse (Pet's. br., pp. 4-6). While it is likely that the bankrupt, which was a large modern corporation, had adequate payroll records, there is no doubt that the task involved does call for effort. But treating the rule sought as one of general applicability would mean that it would also apply to a bankrupt who had only one or two employees with records readily available or easily obtained, in which case the work involved would be truly negligible.

The fact is that the tax reporting work involved in the instant case is not disproportionate to the size of the corporate bankrupt, and it involves little more than the bankrupt itself would have been required to perform in the ordinary course of its business.

POINT II

The claims for withholding tax should be accorded priority as second priority wage claims. If taxes are properly withheld and segregated, they will be trust claims within that second priority category.

(1)

Classifying the claims of the taxing authorities for purposes of determining their place in the scheme of priorities involves a somewhat unusual problem. They do not facilely

fit into any of the various classes of claims described in Bankruptcy Act § 64a (11 U.S.C. § 104). It can be reasonably argued that they can be viewed as wage claims, trust claims or administration claims. But the one classification that they cannot possibly fit into is that of fourth priority tax claims.*

Classification has proven troublesome for the Courts. There is a three-way conflict among five circuits (17a). *Cf. U.S.* v. *Fogarty, supra,* 164 F. 2d 26 (8th Cir., 1947) (administration expense); *Lines* v. *State of California, Department of Employ.,* 242 F. 2d 201 (9th Cir., 1957), rehearing den. with opinion, 246 F. 2d 70 (9th Cir., 1957), cert. den. 355 U.S. 857 (1957) (administration expense); *United States* v. *Curtis,* 178 F. 2d 268 (6th Cir., 1949), cert. den. 339 U.S. 965 (1950) (administration expense); *In re Connecticut Motor Lines, Inc.,* 336 F. 2d 96 (3rd Cir., 1964) (fourth priority taxes); and the instant case, *In re Freedomland, Inc.,* 480 F. 2d 184 (2nd Cir., 1973) (wage claims).

We believe that the proper classification for these claims is that of second priority wage claims. As such, if the trustee handles the withheld taxes as he should, they will also partake of the nature of trust claims—not trust claims superior to administration expenses—but trust claims nevertheless, *for* they are held in trust for the taxing authorities.

(2)

All of the withholding taxes, federal and City, are deducted from and carved out of the payments made to the wage claimants. I.R.C. (26 U.S.C.) § 3401 and § 3101; Admin. Code § T46-51.0 and § U46-8.0. The wage claimants are credited on account of their income taxes with the withheld amounts. I.R.C. (26 U.S.C.) § 31(a); Admin. Code

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* Even the trustee agrees that this is so (Pet's br. pp. 15-16).

§ T46-53.0 and § U46-10.0. Analytically and actually the tax payments constitute a deducted part of the wages of the claimant. They are included in his gross income for income tax purposes as wages and may not be deducted from it. I.R.C. (26 U.S.C.) § 275(a)(1)(A) and (C); Admin. Code § T46-53.0 and § U46-10.0. Instead of being paid directly to the wage earner, they are paid to the taxing authorities for his account. The amount of his wage claim distribution is diminished by their amount. The wage distribution to him is reduced, but the tax authorities receive the balance on his behalf. He may even obtain a refund of the amount withheld if other credits equal or exceed his income tax liabilities. If he receives wages —and he does—the withheld amounts paid to the governments and carved out of his gross wages are also his wages. The tax payments have their genesis in the wages from which they are deducted and derived. Since classification is necessary, the claims of the tax authorities are wage claims, for it is only from wage claim distributions that they are derived and paid.

If the trustee is required to withhold taxes upon payment of the wage claims, the bankruptcy court should and, we believe, will direct him to segregate the amounts withheld* and pay them over to the taxing authorities for which he is the collecting agent. The amounts segregated actually are paid to the taxing authorities on behalf of the wage claimants who are credited with them whether or not the government receives them [I.R.C. (26 U.S.C.) § 31]. Not only does the law provide that they constitute trust funds [I.R.C. (26 U.S.C.) § 7501(a); Admin. Code § T46-55.0 and § U46-12.0] but even without those provisions they are trust funds when they have been segregated. They are taxes collected on behalf of a government, and the trustee, in collecting them by withholding them, is an agent of

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* Cf. Bankruptcy Rules for the Southern and Eastern Districts of New York, Rule XI-5.

the government and holds them, as any other agent holds his principal's funds, in trust.

Nothing that was said or passed upon in *United States* v. *Randall,* 401 U.S. 513 (1971), changes this. In that case, as this Court pointed out, the taxes had never been set aside. There was no trust *corpus* (401 U.S. at p. 515).

Ordinarily, trust claims come before administration expenses. *City of New York* v. *Rassner,* 127 F.2d 703 (2nd Cir., 1942). But the present trust claim cannot enjoy that kind of priority because it is, or will be, a trust which arises upon the payment of and out of the proceeds of a wage distribution which enjoys only a second priority after administration expenses. Moreover, in order to determine the amount of assets available to pay wage claims, all prior claims, including not only administration expenses but those trust claims having super priority, must be calculated. The fact, however, that the claims in issue are not the ordinary kind of trust claims does not make them any less trust claims. Their status as trust claims inheres in their very nature because they are monies set aside after they are carved out of and withheld from distributions made by the trustee.

It makes little difference, however, whether the claims are viewed as trust claims or as wage claims. The result is the same. They are paid only when there are sufficient assets to pay second priority wage claims. They are both trust claims and wage claims. There is nothing inconsistent in so viewing them.

(3)

In *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), the question of priority status was examined and the Court held that the taxes on the wage claim payments were administration expenses entitled to priority under Bankruptcy Act § 64a(1) [11 U.S.C. § 104(a)(1)]. On its peculiar facts we believe that the *Fogarty* case may have been

correct on this point. However, its holding is not inconsistent with our contentions concerning the wage and trust claim status of the withholding tax claims in issue. For in *Fogarty,* there was no segregation of the taxes withheld. Indeed, it is not clear whether any were withheld. They were actually satisfied by setting their amounts off against a claim by the bankrupt against the United States for work performed in building vessels for the Navy.

Nevertheless, this aspect of the *Fogarty* case might be applicable to the case at bar if trust and wage claim status should be denied. The administration claim status of withholding taxes would then follow from the fact that they cannot be classified as taxes "which became legally due and owing by the bankrupt."

It is manifest that the obligations involved will be incurred by the trustee as part of his administration of the bankrupt estate. Part of that administration consists of his performing his duty to withhold these taxes and to pay them over to the proper authorities whenever wage claims are paid. This is an administration duty pure and simple.

The notion expressed in the trustee's brief (Pet's. br. pp. 17-18) and in *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96, 100-101 (3d Cir., 1964), that to qualify as an expense of administration under subdivision (1) of Bankruptcy Act § 64a [11 U.S.C. § 104(a)], the expense must be in preservation of the estate, is a false one. Such preservation expenses are only a small part of the costs of administration which cover a far broader spectrum of expenditures and are not limited to the specific items mentioned in Bankruptcy Act § 64a(1) [11 U.S.C. § 104(a)(1)]. 3A COLLIER ON BANKRUPTCY, pp. 1419, 2093-2098 (14th Ed., 1940).

Nor are the withholding taxes in question the result solely of activities taking place before bankruptcy (Pet's.

br. p. 17). They result from and do not become due until the actual distribution of wage claims by the trustee.

We must, in candor, point out that classifying the claims in question as administration expenses involves an anomaly, for to compute the taxes, the amount payable to the wage claimants must be determined. Those amounts can only be determined by subtracting the sum of the administration expenses and any other higher priority obligations from the funds on hand in the bankruptcy estate. In making this calculation, obviously neither the wage claims nor the taxes on them can be included among the administration expenses. Thus, to consider the wage claims as administration expenses destroys the symmetry of the Bankruptcy Act's scheme of priorities and poses an insoluble mathematical problem.

(4)

The trustee asserts that requiring him to withhold taxes would be tantamount to the imposition of a penalty barred by Bankruptcy Act § 57(j) [11 U.S.C. § 93(j)] (Pet's. br. p. 19). He adverts to Internal Revenue Code (26 U.S.C.) § 6672, and N.Y.C. Administrative Code § U46-35.0(g) and (presumably) § T46-65.0(g), all of which impose a 100% penalty (distinct from and in addition to the tax) on persons who are required to collect, truthfully account for, and pay over withholding taxes and who wilfully fail to do so or who attempt to evade or defeat tax.

This case, however, does not involve any claim for a penalty by either the federal government or the City. The issue the trustee seeks to raise can only arise if the trustee wilfully fails to pay the withholding taxes or wilfully attempts to evade or defeat them.

POINT III

Proofs of claim, other than those for wage claims, were not necessary for the withholding taxes involved.

(1)

The Court below held that there was no requirement that the taxing authorities file proofs of claims for the taxes involved, because it might be impossible to do so until the amounts of wage claims are ascertained (16a). It held that "[t]he filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law" (*ibid.*).

The trustee challenges that holding (Pet's. br. pp. 11-13). The challenge is without merit.

Obviously, the absence of claims is due to the fact that it is not possible to calculate a "maximum tax" even now. Moreover, it would not be possible to file a timely claim for withholding taxes. A withholding tax claim may be made only on the basis of wages claimed. Hence, it cannot be made until the wage claims are filed. Even if it were assumed that the tax rates would remain stable and that the funds would be adequate to pay all wage claims, the governments could not file their withholding tax claims until all wage claims had been filed. It cannot be certain that all are filed until the last day to file them. Then it is too late to calculate and file timely tax claims based on those wage claims.*

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* It is conceivable—though we do not assert that it happened in this case—that a withholding tax claimant would receive no notification of the bankruptcy. For Bankruptcy Act § 58(a) requires notice only to creditors and the United States District Director of Internal Revenue. In such a case the claimant could hardly be expected to file a proof of claim within the required period.

If we are correct in our view that these claims are entitled to wage claim status, no proofs of claim are necessary. The very filing of the wage claim by the wage claimants for the full amount of wages was sufficient to constitute a claim on behalf of the governments because the trustee and referee had before them claims which included the governments' withholding tax claims.

In the *Connecticut Motor Lines* case (336 F. 2d 96, 107), the Court not only found that the claim was a fourth priority tax claim, but disallowed it for failure to file a proof of claim. The consequenses of such a disposition are most inequitable.* The wage claims are reduced by the amount of the taxes withheld, but because no proof of claim was filed the taxing authority does not get those taxes. Nevertheless, the taxing authority cannot levy the tax on the wage claimants because they get full credit for the withholding regardless of the fact that the government has not been paid [I.R.C. (26 U.S.C.), § 31; see Admin. Code § T46-53.0]. The anomalous result was that the government was not paid the withholding taxes, the employees were nevertheless credited with payment of the amounts of the withholding taxes, and the amounts withheld were used to pay general creditors.

(2)

Proofs of claims must state that the claim is justly "owing from the bankrupt to the creditor" [Bankruptcy Act § 57a (11 U.S.C. § 93(a))]. The claims in question were never owing from the bankrupt and are not even owing at this time. The tax liability in question does not come into existence and does not accrue until wages or their equivalents are actually paid. The pertinent language of the New York City tax laws contained in Administra-

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* The Court was fully aware of the anomalous and astonishing results of its holding. See 336 F. 2d at p. 107.

tive Code §T46-51.0(a) and its Title U analogue states that an employer "making payment of any wages taxable under this title shall deduct and withhold from such wages for each payroll period a tax * * *." Payment, actual payment, is a precondition to the withholding and liability for these ttaxes.

The same is true of the federal taxes involved. Internal Revenue Code (26 U.S.C.) § 3402(a), states that "[e]very employer making payment of wages shall deduct and withhold upon such wages * * * a tax * * *." Section 3101 of the Internal Revenue Code (26 U.S.C.) which imposes the employee's share of social security tax, states that "there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages * * * *received by him* * * *" (italics supplied).

Concededly, the Court of Appeals for the Third Circuit reached a contrary conclusion in the *Connecticut Motor Lines* case. That case pointed out (336 F.2d at p. 105), in answer to the claim that the taxes could not be determined or accrue until wages were determined in amount and actually paid and hence could not be "due and owing by the bankrupt", that it was possible to compute both a "maximum wage due" from the bankrupt's records and a "maximum tax due."

No maximum tax, however, can possibly be computed. There is no assurance that the tax rates applicable to the wages will remain the same until the date the wage claims are paid. In this case, the rates did not remain the same and they may be changed again before payment of the wage claims is made. The tax rate at the time of payment of the wages governs.

The wages in question were earned in 1964 when federal individual income tax rates ranged from 16% to 77% [I.R.C. (26 U.S.C.) § 1, as amended by the Revenue Act of 1964, P.L. 88-272, § 111(a), 78 Stat. 19]. From 1965

through the present time, they have ranged from 14% to 70% [*id.*, Revenue Act of 1964 (P.L. 88-272, § 111(b), 78 Stat. 19)], with an intervening tax surcharge (P.L. 90-364, § 102, 82 Stat. 251; P.L. 91-53, § 5, 83 Stat. 91; P.L. 91-172, § 701, 83 Stat. 487).

The withholding rates, however, were subject to much more fluctuation and have increased considerably since the wages involved here were earned.*

The range of social security tax rates is, of course, even greater. They increased from a rate on employees of 3.625% in 1964 to their present rate of 5.85% [I.R.C. (26 U.S.C.) § 3101(a) and (b)].

The New York City taxes involved were increased for the taxable years beginning on or after January 1, 1971 [N.Y.C. Admin. Code, § T46-3.0 and § U46-2.0(a), as last amended by New York City Local Law No. 81 of 1972].

The trustee may have been misguided into assuming a more stable rate structure by the federal government's long standing practice of accepting, in bankruptcy proceedings, 25% as a withholding tax rate for all of its taxes (62a, 81a) and the City's statement in the present case that it will accept 1% (73a). These concessions were made for the sake of facilitating administration and not as *indicia* of the true liability of the trustee. They do not bear upon

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* Between March of 1964 and May of 1966, the withholding rate was 14% above exemptions [P.L. 88-272, § 302(b), 78 Stat. 19]. After May 1, 1966, the rates were placed on a progressive graduated scale running between 14% and 30% [P.L. 89-368, § 101(c), 80 Stat. 38]. After July 13, 1968, they were increased to a maximum of 33% [P.L. 90-364, § 102(c) 82 Stat. 251; P.L. 91-36, § 2(a)(2), 83 Stat. 42; P.L. 91-53, § 6(a)(2), 83 Stat. 91], then jumped to a range of 21% to 31% between January 1, 1970 and June 30, 1970 [P.L. 91-172, § 805(a), 83 Stat. 487], with the maximum rate dropping to 30% for the following half-year period (*ibid.*). For the year 1971, the rates were from 14% to 25% (*ibid.*) and then, beginning January 1, 1972, increased to 14% to 36% [P.L. 92-178, § 208(a), 85 Stat. 497].

the question of whether a maximum tax as of the time that the wages accrue is calculable. It is manifest, if only by reason of the fluctuation in tax rates, that no such projection can or could have been made.

The taxes were never "owing from the bankrupt" and could not have been calculated at the time the wages were earned. They will be due and may be calculated only when the wage claims are paid and not until then.

(3)

The basis of our argument here finds agreement in the trustee's brief. For in arguing against "fourth priority" status (Pet's. br. pp. 15-16), he states that the withholding taxes are not "owing by the bankrupt" and he points out (Pet's. br. p. 16) that the taxes cannot be due and owing until the wage claims are actually paid.

(4)

Each of the forms for proofs of claims which this Court has promulgated with its General Orders in Bankruptcy (Forms 28, 29, 30 and 31) requires a statement that "the • • • bankrupt, was at and before the filing by [*or* against] him of the petition for adjudication of bankruptcy, and still is, justly and truly indebted [*or* liable] to" the claimant. Such a statement could not possibly be subscribed by the taxing authorities here, for the bankrupt was never indebted to them for the withholding taxes.

CONCLUSION

The order of the United States Court of Appeals, for the Second Circuit, should be affirmed.

March 22, 1974.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, TRUSTEE IN BANKRUPTCY OF FREEDOMLAND, INC., PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (A. 70a–91a) is reported at 341 F. Supp. 647. The opinion of the court of appeals (A. 5a–17a) is reported at 480 F. 2d 184.

JURISDICTION

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973, and was granted on January 21, 1974. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a trustee in bankruptcy must withhold federal income and FICA taxes from payment of wage claims made under Section 64a(2) of the Bankruptcy Act and prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld.

2. Whether the United States is required to file a proof of claim with respect to withholding taxes on priority wage claims.

3. Whether withholding taxes on priority wage payments constitute first, second, or fourth priority debts under Section 64a of the Bankruptcy Act.

STATUTES INVOLVED

Sections 57, 63 and 64 of the Bankruptcy Act, as amended, 11 U.S.C. 93, 103, and 104, provide in pertinent part as follows:

> Section 57a. A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim; the consideration therefor; whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor. A proof of claim filed in accordance with the requirements of [the Bankruptcy Act], the General Orders of the Supreme Court, and the official forms, even though not verified under oath, shall constitute prima facie evidence of the validity and amount of the claim.
>
> * * * * *

j. Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

* * * * *

n. Except as otherwise provided in this Act, all claims provable under this [Act], including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. * * *

* * * * *

Section 63a. Debts of the bankrupt may be proved and allowed against his estate which are founded upon * * * (8) contingent debts and contingent contractual liabilities; * * *.

* * * * *

Section 64a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be

(1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; * * *

(2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on

> salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; * * *
>
> (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy * * *.
>
> * * * * *

Sections 3101, 3102, 3121, 3401, 3402, 3403, 6001, 6011, and 6051 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. 3101, 3102, 3121, 3401, 3402, 3403, 6001, 6011, and 6051, provide in pertinent part as follows:

> Section 3101. (a) In addition to other taxes, there is hereby imposed on the income of every individual [an old-age, survivors, and disability insurance] tax * * *.
>
> * * * * *
>
> Section 3102. (a) The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. * * *
>
> (b) Every employer required so to deduct the tax shall be liable for the payment of such tax * * *.
>
> * * * * *
>
> Section 3121. (a) For purposes of this chapter, the term "wages" means all remuneration for employment * * *.
>
> (b) For purposes of this chapter, the term "employment" means * * * any service, of whatever nature, performed * * * by an employee for the person employing him * * *.
>
> * * * * *

Section 3401. (a) For purposes of this chapter [relating to withholding of income taxes], the term "wages" means all remuneration * * * for services performed by an employee for his employer * * *.

(d) For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages * * *.

* * * * *

Section 3402. (a) Every employer making payment of wages shall deduct and withhold upon such wages [an income] tax.

* * * * *

Section 3403. The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter * * *.

* * * * *

Section 6001. Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. * * *

* * * * *

Section 6011. (a) When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

* * * * *

Section 6051. (a) Every person required to deduct and withhold from an employee a tax under section 3101 or 3402, * * * shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year, on or before January 31 of the succeeding year, or, if his employment is terminated before the close of such calendar year, on the day on which the last payment of remuneration is made, a written statement showing the following:

(1) the name of such person,

(2) the name of the employee (and his social security account number if wages as defined in section 3121(a) have been paid),

(3) the total amount of wages as defined in section 3401(a),

(4) the total amount deducted and withheld as tax under Section 3402,

(5) the total amount of wages as defined in section 3121(a), and

(6) the total amount deducted and withheld as tax under section 3101 * * *.

* * * * *

(d) A duplicate of any statement made pursuant to this section and in accordance with regulations prescribed by the Secretary or his delegate shall, when required by such regulations, be filed with the Secretary or his delegate.

STATEMENT

Freedomland, Inc. filed a petition for an arrangement under Chapter XI of the Bankruptcy Act, 11 U.S.C. 701 *et seq.*, on September 15, 1964. The arrangement failed, and Freedomland was adjudicated a bankrupt on August 30, 1965. Petitioner was appointed trustee in bankruptcy (A. 27a).

During the six-month statutory period for filing proofs of claims against the bankrupt estate (see Sections 57 and 63 of the Bankruptcy Act, 11 U.S.C. 93 and 103), 413 former employees of Freedomland filed proofs of claims for unpaid wages, aggregating approximately $80,000, that had been earned prior to the filing of the Chapter XI petition and for which the employees were entitled to priority of payment under Section 64a(2) of the Act (A. 72a). The United States did not file proofs of claims for the income and FICA taxes which would arise upon the payment of those priority wage claims, on the theory that those taxes were not "[d]ebts of the bankrupt" under Section 63 of the Act.

Under Internal Revenue Service directives, a trustee in bankruptcy, upon paying priority wage claims, has the option of withholding income and FICA taxes at either a combined flat rate of 25 percent or at the rates prescribed by Sections 3101 and

3402 of the Internal Revenue Code of 1954, 26 U.S.C. 3101 and 3402 (see A. 29a). Petitioner, however, contended before the bankruptcy referee that the 25 percent rate would result in substantial over-withholding and that determination of the exact amounts due, plus compliance with the reporting requirements of the Code, would involve "a massive burden" (A. 31a). The referee agreed with petitioner that the withholding and reporting requirements of the Code "impose a * * * burden on the administration of [bankrupt] estates which is entirely inconsistent with the objective of efficient expeditious economic administration * * *" (A. 36a). The referee accordingly authorized petitioner to pay the wage claims without any withholding for taxes and further held that petitioner was not required to pay over to the United States any income or FICA taxes, to file any returns with the Internal Revenue Service, or to provide any reports to the employees or the Service with respect to the payment of the wage claims (A. 48a–50a).

The United States appealed to the United States District Court for the Southern District of New York. After a hearing, the district court concluded that only a simple bookkeeping effort would be involved in withholding 25 percent of the wage distributions and in complying with the reporting requirements of the Code. The court then held, relying principally upon *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8), that a trustee in bankruptcy must withhold and pay over income and FICA taxes out of priority wage payments and prepare and submit the appropriate

information reports and returns. The court further held that such taxes are not expenses of administration entitled to first priority under Section 64a(1) of the Act but rather are "taxes which became legally due and owing by the bankrupt" and therefore entitled only to fourth priority under Section 64a(4). Finally, the court held that prior proofs of claims need not be filed with respect to such taxes, because the employees' proofs of claims with respect to their prebankruptcy wages fully apprise the trustee and other creditors of the total amounts that will be distributable, as wages and taxes, on account of such claims.

The court of appeals affirmed as to petitioner's obligation to withhold and pay over the income and FICA taxes and to prepare and submit the appropriate reports and returns. The court also affirmed the district court's conclusion that no proofs of claims were required with respect to such withholding taxes. The court of appeals disagreed, however, with the district court's holding that the government's claim for the withholding taxes was entitled only to a fourth priority. The court reasoned that since those taxes could not have been determined at the date of bankruptcy they were not "legally due and owing by the bankrupt" within the meaning of Section 64a(4). The court concluded that withholding taxes "should be treated in the same way as the wages from which they derive" (A. 15a), *i.e.*, as second-priority items under Section 64a(2) of the Act.

SUMMARY OF ARGUMENT

I

The Internal Revenue Code requires trustees in bankruptcy to withhold federal income and FICA taxes from payments of wage claims made under Section 64a(2) of the Bankruptcy Act and to prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld.

Federal income tax withholding is required of every "employer" making payment of "wages." The term "wages" covers all remuneration for employment services, and the Secretary's regulations have long expressly provided that "[r]emuneration for services * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3401(a)–1(a)(5). The payment of wage claims in bankruptcy is therefore the payment of "wages" for income tax withholding purposes. Similarly, Section 3401(d)(1) of the Code specifies that when the common-law employer has lost control of the payment of wages, "the person having control of the payment of such wages" is responsible for withholding. Petitioner, as the person who controls the payment of wage claims, is therefore the "employer" responsible for withholding the tax.

The argument is substantially the same for the FICA tax. But an additional consideration with respect to that tax is that the wage payments are

"wages" for Social Security Act purposes, and withholding and reporting are necessary to ensure that the employee's account is properly credited and that the United States receive the payment necessary to fund that credit.

It is undisputed that petitioner must comply with the withholding tax reporting requirements of the Code if he is required to withhold. These reporting requirements are not seriously burdensome, and are in any event valid federal statutory requirements.

II

The United States is not required to file proofs of claims with respect to withholding taxes on priority wage claims.

Formal proof is required only of debts from which the bankrupt is released by a discharge in bankruptcy. Thus only debts of the bankrupt are "provable" in bankruptcy; proofs of claims need not be filed with respect to the separate debts of the estate. The withholding taxes here arise only upon payment of the wage claims by petitioner on behalf of the estate; accordingly, they arise as debts of the estate, not of the bankrupt.

Moreover, the filing of formal proofs of claims with respect to withholding taxes on priority wage claims is impracticable, for the taxes are not computable until the amount of wages to be paid and the tax rate in effect at the time of payment are both known. In any event, such filings would serve no purpose under the Bankruptcy Act, for the filings of proofs of priority wage claims adequately apprise

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all parties of the total amounts, including withholding taxes, that may be payable out of the estate on account of such claims.

III

Withholding taxes on priority wage payments are first priority debts under Section 64a of the Bankruptcy Act.

Since the taxes are payable out of the employees' share of the estate, and the employees receive appropriate federal income tax and Social Security credits on account of those taxes, no creditors are harmed by payment of the taxes as priority debts. In contrast, treatment of the taxes as general unsecured claims would confer an unjustifiable windfall upon other creditors in many cases.

The withholding taxes that arise upon payment of priority wage claims in bankruptcy are necessary costs incurred in the course of administering the estate and as such are "costs and expenses of administration" entitled to first priority of payment. The fact that these taxes do not contribute to the "preservation" of the estate is irrelevant under the Act; it is well established that a wide variety of administrative expenses, bearing no relationship to the preservation of the estate, are entitled to first-priority treatment.

First-priority treatment is the only means of assuring that the withholding taxes will be paid in full once collected, and it is the only administratively feasible treatment of such taxes. In contrast, second-priority treatment in some instances would result in nonpayment of the tax and entail far greater com-

plexity in calculating distributions. Moreover, second-priority treatment under the Act is reserved for "wages * * * due to workmen," and the claim of the United States here is not for wages but for taxes that arise in the course of administering the estate.

ARGUMENT

This case involves the treatment of withholding taxes on the payment of priority wage claims under Section 64a(2) of the Bankruptcy Act, *i.e.*, on wages earned before but paid after bankruptcy. But the issues raised here may be placed in perspective by first considering the treatment of withholding taxes on wages in two other common bankruptcy situations.

When the wages in question are both earned and paid prior to bankruptcy, it is undisputed that the employer is required to withhold both income and FICA taxes under Sections 3402 and 3102 of the Internal Revenue Code. If the employer at the time of making payment properly segregates the withholding taxes in a trust fund pursuant to Section 7501 of the Code, in our view that fund would be separately payable to the United States notwithstanding any intervening bankruptcy; it would not become part of the bankrupt estate. See *Nicholas* v. *United States*, 384 U.S. 678, 690–691; *United States* v. *Randall*, 401 U.S. 513, 515. If the employer had failed to segregate withholding taxes prior to bankruptcy, the trustee in bankruptcy would nevertheless be obligated to pay over those taxes to the United States as a fourth-priority item under Section 64a(4) of the Bankruptcy Act, relating to "taxes which became legally due and

owing by the bankrupt." Since such taxes are "[d]ebts of the bankrupt" within the meaning of Section 63 of the Act, the United States is required to file proofs of claims with respect to those taxes under Section 57.

It is similarly undisputed that the trustee in bankruptcy is required to withhold income and FICA taxes on wages that are both earned and paid after bankruptcy. Those taxes are payable to the United States either as a special trust fund under Section 7501 of the Code or as a cost and expense of administration under Section 64a(1) of the Act. See *Boteler* v. *Ingels*, 308 U.S. 57; *Nicholas* v. *United States*, *supra*. Since such taxes are not obligations of the debtor in bankruptcy, no proof of claim is required under Section 57 of the Act. See 3A Collier, *Bankruptcy*, ¶ 63.03, n. 1.[1]

In either case the person or persons responsible for withholding the taxes and for paying them over to the United States is required under Sections 6001, 6011, and 6051 of the Code, to furnish appropriate information reports and returns to the Internal Revenue Service and the employees whose wages are subject to withholding.

Petitioner contends that the circumstances of this case are uniquely different—that when wages earned before but paid after bankruptcy are involved, the trustee in bankruptcy is excused from the withholding and reporting requirements under the Code. Petitioner further contends that even if the trustee is required to withhold and report such taxes, they con-

[1] All references to Collier are to the 14th edition.

stitute "[d]ebts of the bankrupt" which are payable only if the United States has filed prior proofs of claims. Petitioner finally contends that at best such taxes are payable only as nonpriority items. We turn now to a discussion of these contentions.

I

A TRUSTEE IN BANKRUPTCY MUST WITHHOLD FEDERAL INCOME AND FICA TAXES FROM PAYMENTS OF WAGE CLAIMS MADE UNDER SECTION 64a(2) OF THE BANKRUPTCY ACT AND PREPARE AND SUBMIT TO THE WAGE CLAIMANTS AND THE INTERNAL REVENUE SERVICE APPROPRIATE INFORMATION REPORTS AND RETURNS WITH RESPECT TO THE AMOUNTS WITHHELD

Every court of appeals before which the question has been raised, including the court below, has concluded that the Internal Revenue Code requires trustees in bankruptcy to withhold federal income and FICA taxes from payments of wage claims made under Section 64a(2) of the Bankruptcy Act and to prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld. *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8); *United States* v. *Curtis*, 178 F. 2d 268 (C.A. 6), certiorari denied, 339 U.S. 965; *In re Connecticut Motor Lines*, 336 F. 2d 96 (C.A. 3). See also, *Lines* v. *California Department of Employment*, 242 F. 2d 201 (C.A. 9), certiorari denied, 355 U.S. 857. As we now show, these decisions rest upon a sound statutory basis and do not result in the imposition of an undue burden on the administration of bankrupt estates.

A. THE INTERNAL REVENUE CODE REQUIRES THE WITHHOLDING OF FEDERAL INCOME AND FICA TAXES FROM PRIORITY WAGE CLAIM PAYMENTS AND THE SUBMISSION OF INFORMATION REPORTS AND RETURNS WITH RESPECT TO THE AMOUNTS WITHHELD

1. Sections 3402 and 3102 of the Internal Revenue Code require a trustee in bankruptcy to withhold Federal income and FICA taxes from priority wage claim payments

a. *Income tax withholding.* Withholding of federal income taxes is required by Section 3402 of the Code, which provides that "[e]very employer making payment of wages shall deduct and withhold upon such wages * * * a tax determined in accordance with the [withholding tax] tables." Petitioner contends (Br. 8–11) that the payment of priority wage claims does not constitute the payment of "wages," and that the trustee in bankruptcy is not the "employer" of the wage claimants, within the meaning of that provision.

(1) Section 3401(a) broadly defines the term "wages" for income tax withholding purposes as "all remuneration * * * for services performed by an employee for his employer." The payments here are being made as remuneration for the services performed by the wage claimants, as employees, for their former employer, Freedomland, Inc., before its bankruptcy. See Section 3401(c) and (d) (defining "employee" and "employer"). Petitioner contends, however, that the statutory definition of "wages" does not cover remuneration for prior employment made after termination of the employment relationship. This contention is inconsistent with the statutory text and directly contrary to the long-standing administrative construction.

Section 3401(d) defines "employer," at least for purposes of the definition of "wages" under Section 3401(a) (see the parenthetical exception in Section 3401(d)(1)), as "the person for whom an individual *performs or performed* any service" (emphasis added). We believe that Congress used both present and past tenses ("performs or performed") in the alternative in order to specify that the characterization of a payment as "wages" is not dependent upon the existence of a continuing employment relationship. This has long been the Secretary's construction. The income tax withholding regulations since 1943 have provided that "[r]emuneration for services * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3401(a)-1(a)(5). See Sections 404.101 of Treasury Regulations 115, 405.105 of Treasury Regulations 116 (1944 & 1951 eds.), and 406.205 of Treasury Regulations 120, all under the 1939 Code. Petitioner suggests no reason why these regulations should not apply here.[2]

[2] Petitioner principally relies upon Rev. Rul. 69-136, 1969-1 Cum. Bull. 252, and Rev. Rul. 55-520, 1955-2 Cum. Bull. 393. The issue involved in those rulings, however, was not whether remuneration for prior employment constituted "wages" but rather whether the payments there in question had been made as "[r]emuneration for services" or for some other reason. They therefore do not support petitioner's contention that post-termination wage payments are not subject to withholding. Nor does *United States* v. *Embassy Restaurant*, 359 U.S. 29, upon which petitioner also relies, support that contention. *Embassy Restaurant* (as well as a later, similar case, *Joint Industry*

The Secretary's regulations conform with the plain language of the statute and further the underlying congressional purpose of providing for the collection of income taxes on employment income at the source. They are reasonable and should be sustained. See, *e.g.*, *Cammarano* v. *United States*, 358 U.S. 498.[3]

(2) Section 3401(d)(1) provides that "if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term 'employer' (except for purposes of [the definition of 'wages' under] subsection (a)) means the person having control of the payment of such wages." Petitioner concedes the applicability of that provision, but he contends that the bankruptcy referee's participation in the payment of wage claims is such that it is the referee, rather than the trustee, who has "control of the payment of such wages." There are of course legal constraints on the trustee's power to distribute the assets of the estate; he must secure the prior order and countersignature

Board v. *United States*, 391 U.S. 224) involved the question whether certain payments constituted "wages" within the meaning of Section 64a(2) of the Bankruptcy Act. No such question arises in this case: petitioner, by applying for an order authorizing payment of the employees' claims here, has conceded that those claims are for "wages" for the purposes of that Act. Indeed, if, as petitioner seems to suggest by his reliance on *Embassy Restaurant*, the Bankruptcy Act definition of "wages" governs this case, the priority wage payments here are *a fortiori* subject to withholding.

[3] Moreover, the regulations presumably were approved and adopted by Congress in enacting the same substantive withholding provisions into the 1954 Code. See, *e.g.*, *Lykes* v. *United States*, 343 U.S. 118, 127; *Helvering* v. *Winmill*, 305 U.S. 79, 82–83.

of the referee before making payment of claims. See Section 39a(5) of the Act. Yet the trustee is responsible for recommending allowance or disallowance of claims and for making actual payment (see Section 47a(8) and (11)) as well as for administering the bankrupt estate. See generally 2 Collier, *Bankruptcy*, ¶ 47. We do not believe that the referee's responsibility for overseeing the general administration of the estate deprives the trustee of "control of the payment of such wages" within the meaning of Section 3401 (d)(1), which is primarily concerned with the practical question of who is in a position to withhold the tax. Cf. *King* v. *United States*, 379 U.S. 329.[4] "The purpose is to treat the actual payor of the remuneration as the employer for withholding and payment purposes." *United States* v. *Fogarty, supra*, 164 F. 2d at 32.

But petitioner's argument also fails for a more fundamental reason. If, as petitioner contends, the referee controls the payment of wages for withholding purposes (or if the referee and trustee jointly exercise "control"), the wage payments would nevertheless remain subject to withholding. The referee, as the "employer," would be under a duty to order the trustee to withhold the tax. As the court of appeals

[4] Since petitioner exercises "control of the payment of * * * wages" in a representative rather than personal capacity, we believe that, as a technical matter, it is correct to view the estate and not the trustee as the "employer." Under this view, petitioner's duty to withhold derives from his fiduciary responsibility for administration of the estate, which is itself the "employer." This is also the rule when employees are hired by the trustee to perform services for the estate. 26 C.F.R. 31.3401(d)-1(c); Rev. Rul. 69-657, 1969-2 Cum. Bull. 189.

stated in *United States* v. *Fogarty, supra,* 164 F. 2d at 32:

> The result would be no different if it is argued that the bankruptcy court rather than its trustee is "the person having control of the payment of such wages." There is no provision excepting a court from the requirement of withholding on amounts paid an employee * * *.

b. *FICA Withholding.* The withholding of FICA taxes is governed by provisions that are virtually identical in substance to those just discussed, and petitioner does not separately argue the question of FICA withholding. We set forth here only the considerations that specially pertain to the FICA tax.

Section 3102(a) of the Code provides that the FICA tax "shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid." The wage payments here are clearly "wages" for the purpose of that provision. As is the case with income tax withholding (see p. 17, *supra*), the Secretary's FICA withholding regulations have provided since the early 1940's that "[r]emuneration for employment * * * constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them." 26 C.F.R. 31.3121(a)–1(i). See Sections 402.227(a) of Treasury Regulations 106, and 408.266(a) of Treasury Regulations 128, both under the 1939 Code. This conforms with the

treatment of such wage payments under the Social Security Act. See 20 C.F.R. 404.1026(a)(9).

The FICA withholding provisions of the Code do not specifically define the term "employer." There is, however, no reason for giving that term a narrower construction under the FICA withholding provisions than it has for income tax withholding purposes. The FICA withholding provisions were intended to be construed *in pari materia* with the Social Security Act: the wages that give rise to a credit under that Act must be subject to withholding (and also to the reporting requirements of the Code; see p. 22, *infra*) in order for the employee's account to be properly credited and for the United States to receive the payment necessary to fund the credit. See H. Rep. No. 615, 74th Cong., 1st Sess., pp. 21, 32. And those "taxing provisions are concerned with the character of the payments as wages rather than with the relationship of the payor to the payee * * *." *United States* v. *Fogarty, supra,* 164 F. 2d at 30. The payments here were "wages" within the meaning of the Social Security Act. 20 C.F.R. 404.1026(a)(9). Cf. *Social Security Board* v. *Nierotko,* 327 U.S. 358. They are therefore subject to withholding. Petitioner, as the person responsible for making the wage payments, should be treated as the "employer" within the meaning of Section 3102. Cf. S.S.T. 199, 1937–2 Cum. Bull. 405 (Question 5).

2. Information reports and returns must be submitted with respect to withheld Federal income and FICA taxes

Section 6051(a) of the Code provides that every person required to deduct and withhold federal income or FICA taxes must furnish the employee with a written statement showing the total amount of wages subject to withholding and the amounts deducted and withheld on account of each tax. A duplicate copy of this statement must be filed with the Internal Revenue Service. See Section 6051(d). Sections 6001 and 6011 further require every person liable for payment or collection of a tax to keep such records, render such statements, and make such returns as the Secretary prescribes.

Applicable Treasury Regulations promulgated pursuant to those provisions require persons liable for withholding to furnish the Service (on Forms W–2, W–3, and 941)[5] with the names and Social Security numbers of their employees and the amounts of gross wages paid, taxable FICA wages paid, and federal income and FICA taxes withheld, as to each. See 26 C.F.R. 31.6001–2, 31.6001–5, 31.6011(a)–6(a)(1), and 31.6051–1; Rev. Proc. 71–18, 1971–1 Cum. Bull. 684.

It is undisputed that petitioner must comply with these provisions if he is subject to the withholding requirements of Sections 3402 and 3102.

[5] Copies of these forms are being lodged with the Clerk of this Court.

B. THE COSTS OF COMPLYING WITH THE WITHHOLDING AND REPORTING REQUIREMENTS OF THE CODE DO NOT JUSTIFY A REFUSAL TO COMPLY

Throughout this litigation, petitioner's principal stated objection to complying with the withholding and reporting requirements of the Code has been that compliance is costly. This objection is wholly without merit. The actual costs of compliance are insubstantial, and those costs are in any event irrelevant to the issue of petitioner's statutory obligation to comply.

The bankruptcy referee, without taking any evidence on the subject, asserted that compliance with the withholding and reporting requirements entails a burden that "is entirely inconsistent with the objective of efficient expeditious economic administration of bankrupt estates" (A. 36a). This assertion apparently was based solely on an article written by another bankruptcy referee, which cites no evidence other than that referee's personal knowledge of one instance where it cost an estate approximately $600 to comply with all withholding and reporting requirements (see A. 38a–47a). The district court, upon review of the referee's order, took evidence with respect to the costs of compliance. After summarizing the evidence (A. 77a–81a), the court concluded that "[c]ompliance with [the withholding and reporting] requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment" (A. 81a).[6]

[6] Petitioner contends (Br. 20–22) that the district court should have affirmed the referee's ruling as not clearly erroneous. The "clearly erroneous" standard, however, applies only to "findings of fact" (Rule 810, Rules of Bankruptcy Procedure) and the ref-

The district court was clearly correct in its evaluation of the nature of the burden imposed by the withholding reporting requirements. For those trustees who elect to withhold at the flat 25 percent rate, the necessary withholding tax computations are elementary.[7] For other trustees, the computations involved are merely those that would have been required of the employer prior to bankruptcy, and that are required of all employers in the ordinary course of business. Nor is preparation of the necessary reports and returns costly or difficult. The applicable forms (W-2, W-3, and 941) request only information that should be readily available to the trustee.[8] As the district court found, these "forms can

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eree made no such findings. Under the circumstances, we believe the district court acted properly in taking evidence in order to become informed "as to what burdens are in fact imposed" (A. 77a).

[7] Petitioner now alleges that "no evidence exists in the record that [the 25 percent] rule exists" (Br. 22). He overlooks that he himself asserted the existence of that rule in his application to the referee (A. 29a). At one point in this litigation petitioner contended that the 25 percent rate was too high. He appears to have abandoned that contention. In any event, the combined 25 percent rate is not unreasonable. Income withholding tax rates under Section 3402 range from 14 to 36 percent; the FICA withholding rate under Section 3101(a) and (b) is currently 5.85 percent.

[8] As we indicated above (p. 22, *supra*), the trustee is required to supply only the name and Social Security number of the wage claimant, his gross and taxable FICA wages paid, and the amount of federal income and FICA taxes withheld. The trustee necessarily secures all this information in the course of verifying the wage claim and calculating the tax. (The employment records of the bankrupt estate should include the claimant's Social Security number, but the claimant is in any event required to supply that number on his proof of return. See Form 16, Official Bankruptcy Forms.)

be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee" (A. 79a).[9]

Moreover even if the withholding and reporting requirements of the Code were shown to be burdensome, petitioner's obligation to withhold and report would not thereby be excused. Cf. *Swarts* v. *Hammer*, 194 U.S. 441, 444. The extent to which bankrupt estates should be exempted from the responsibilities imposed upon other taxpayers is a matter of legislative judgment and discretion; although the Code relieves some insolvents from certain specific tax liabilities,[10] Congress has expressly provided that bankruptcy trustees are otherwise subject to the same taxes as ordinary business taxpayers. 28 U.S.C. 959. See, *e.g.*, *Boteler* v. *Ingels*, *supra*. See, also, *United States* v. *Sampsell*, 266 F. 2d 631 (C.A. 9). In contrast, nothing in the Bankruptcy Act or the Code, either expressly or by fair implication, exempts bankrupt estates and their trustees from the duty to withhold and report. The reasons for this are obvious. Since the wage claim payments are "wages" for Social Security Act purposes (see p. 21, *supra*), the trustee's failure to withhold and report FICA taxes (1) could deny the employee the Social Security credit to which he is entitled under that Act and (2) would deprive the United States of the payment necessary to fund that credit.

[9] Moreover, we have been informed by the Service that its practice is to assist bankruptcy trustees and other fiduciaries in the preparation of these forms where such assistance is requested.

[10] Section 7507 exempts insolvent banks from the income tax; Section 108(b) exempts insolvent railroads from the recognition of income from the forgiveness of indebtedness; Sections 371 and 372 provide for tax-free reorganizations of certain bankrupt estates.

Similarly, failure to withhold income taxes from the wage payments would frustrate *pro tanto* the purposes of the income tax withholding provisions, which are to ensure timely collection of the tax and to assist individuals in making prompt payment.

Furthermore, petitioner's argument finds no support in either the Bankruptcy Act or the general policies that underlie it. Nothing in that Act relieves the trustee from his duty to withhold and report. Petitioner apparently relies upon his general obligation to conserve the assets of the bankrupt estate and protect its interests. But that obligation, which is little different from that imposed on other fiduciaries, does not override affirmative statutory responsibilities.[11]

[11] Petitioner further contends (Br. 19) that withholding taxes on priority wage claims are barred as penalties under Section 57j of the Bankruptcy Act. This contention is wholly without merit. Section 57j provides that debts owing from the bankrupt to the United States "as a penalty or forfeiture shall not be allowed." As we show below (pp. 28–30, *infra*), withholding taxes are not debts owing by the bankrupt. Moreover, the federal income and FICA withholding taxes imposed by Sections 3101 and 3402 of the Code are in no sense penalties or forfeitures. It is true that if the trustee fails to withhold he may become personally liable for a penalty equal in amount to the withholding taxes. See Section 6672 of the Code. But Section 57j of the Act does not purport to protect the trustee personally from the assessment of penalties resulting from his maladministration of the estate; it applies only to penalties payable out of the estate. See generally 3 Collier, *Bankruptcy*, ¶ 57.22.

II

THE UNITED STATES IS NOT REQUIRED TO FILE PROOFS OF CLAIMS WITH RESPECT TO WITHHOLDING TAXES ON PRIORITY WAGE CLAIMS

A. THE BANKRUPTCY ACT DOES NOT REQUIRE THE FILING OF PROOFS OF CLAIMS WITH RESPECT TO SUCH TAXES

Petitioner contends (Br. 11–13) that the United States must file proofs of claims under Section 57 of the Bankruptcy Act with respect to income and FICA withholding taxes on priority wage payments. In so contending, petitioner fails to make a necessary distinction between the liabilities of the bankrupt and those of the estate.

The "bankrupt" is the debtor—the person who files a voluntary petition in bankruptcy or against whom an involuntary petition is filed. Section 1(4) of the Act. The filing of the petition places the bankrupt's nonexempt property, its "estate," under the custody of the bankruptcy court. See Section 2 of the Act. The trustee, upon his appointment and qualification, is vested with title to the estate. Section 70 of the Act. The primary purpose of a bankruptcy proceeding is to provide for the orderly and equitable distribution of the estate among the bankrupt's creditors. However, during the course of administration the estate also incurs its own liabilities. The Bankruptcy Act treats the estate's liabilities and those of the bankrupt very differently.

The bankrupt's liabilities are satisfied, in full or in part, through the procedure of proving and allowing claims, a procedure that begins with the filing of proofs of claims. Section 57n of the Act requires that

"all claims provable under the Act * * * shall be proved and filed * * * within six months after the first date set for the first meeting of creditors." Section 63 further specifies that the claims provable under the Act are the "[d]ebts of the bankrupt." Thus unsecured creditors of the bankrupt must file formal proofs of claims in order to participate in the distribution of the assets of the estate. In contrast, the estate's creditors—creditors asserting debts of the estate rather than of the bankrupt—are not required to file proofs of claims. See generally 3 Collier, *Bankruptcy*, ¶ 57.34; 3A Collier, *Bankruptcy*, ¶ 63.03. Those claims may be paid by the trustee, upon the referee's order, without the filing of formal proofs. Thus whereas obligations of the bankrupt are paid on the basis of distributive shares after proof and allowance of claims, obligations incurred by the estate are generally separately payable as expenses of administration. See *Reading Co.* v. *Brown*, 391 U.S. 471.

In contending that proofs of claims were required with respect to the withholding taxes here, petitioner therefore is necessarily asserting that those taxes are liabilities that have been or will be incurred by Freedomland, the bankrupt, and not merely by the estate in the course of administration. But petitioner concedes (Br. 15–16), as he must, that the withholding taxes were not legally due and owing by Freedomland at the time of the adjudication of bankruptcy. Withholding taxes arise only when the wages are paid, not at the earlier time when they first accrue. See, *e.g.*, 26 C.F.R. 31.3402(a)–1(b) (providing that "[t]he employer is required to collect the tax by deducting

and withholding the amount thereof from the employee's wages *as and when paid"*; emphasis added).[12] It is therefore clear that Freedomland had incurred no liability for the withholding taxes at the time it was adjudicated a bankrupt.

Petitioner claims, however, that Freedomland was contingently liable for the taxes at the time of bankruptcy and therefore that the government's claims for those taxes were provable as "contingent debts" of the bankrupt under Section 63a(8) of the Bankruptcy Act. But although Freedomland would have been liable for the taxes if it had paid the wages, it was not, as bankrupt, contingently liable for taxes that would arise only upon payment of the wage claims by the trustee; petitioner confuses the separate liabilities of the estate and the bankrupt. That same confusion also underlies the ruling on this point in *In re Connecticut Motor Lines, supra,* on which petitioner relies. As we have shown above (pp. 18–20, 21, *supra*), the person who pays the wages is the one responsible for collecting and paying over the taxes. Petitioner apparently assumes that the bankrupt, as the employer at common law, necessarily becomes liable for payment of the withholding taxes upon the trustee's payment of the wages; but the common-law employer is liable for those taxes only if it "control[s] * * * the payment of * * * wages" (Section 3401(d)(1) of the Code), and the common-law employer here lost control

[12] The tax also arises upon constructive payment of the wages, but constructive payment requires, *inter alia*, that the wages "be made available to [the employee] so that they may be drawn upon at any time * * *." 26 C.F.R. 31.3402(a)-1(b). No question of constructive payment is involved here.

of the payment of wages upon the adjudication of bankruptcy. It is petitioner, acting on behalf of the estate (see note 4, *supra*), who is now responsible for paying the wages; accordingly, the withholding taxes arise as liabilities of the estate, not of the bankrupt. For example, a failure by petitioner to withhold or pay over the taxes could give rise to the assessment of a civil penalty against him personally (see note 11, *supra*), but it would not give rise to any liability on the part of the bankrupt. Thus the withholding taxes here are in no sense "[d]ebts of the bankrupt," contingent or otherwise.

The distinction drawn here between debts of the bankrupt and debts of the estate is not merely technical; it is central to the Bankruptcy Act's organizational scheme. Provability is linked to dischargeability under the Act: "provable" debts are debts from which the bankrupt is released by a discharge in bankruptcy. See Section 17 of the Act. A bankrupt does not need to be released from debts—such as the claims for withholding taxes here—for which third parties are exclusively liable. The Act therefore requires no "proof" of such debts under Section 57. We believe that these general considerations illustrate the fundamental nature of petitioner's error in relying upon Section 63a(8), which permits proof of the bankrupt's "contingent debts." That provision was enacted in 1938 for the purpose of granting additional relief to bankrupts: debts that formerly had survived bankruptcy as personal obligations of the bankrupt were made subject to proof and release. See generally 3 Collier, *Bankruptcy*, ¶ 57.15; 3A Collier, *Bankruptcy*,

¶ 63.30. Thus both the specific language and the purpose of that provision restrict its application to "[d]ebts of the bankrupt;" it can have no application to claims, such as those here, for which the bankrupt would never be liable anyway. Certainly Section 63a(8) was not intended to interpose procedural obstacles to the enforcement of the separate liabilities of the estate.

B. THE FILING OF PROOFS OF CLAIMS WITH RESPECT TO SUCH TAXES WOULD BE IMPRACTICAL AND WOULD SERVE NO PURPOSE

Practical considerations reinforce the foregoing statutory analysis. The filing of a proof of claim is a ministerial act intended to incorporate the proof into the records of the court. See 3 Collier, *Bankruptcy*, ¶57.10. The purpose of the filing is to apprise the trustee and other creditors of the claims outstanding against the bankrupt. But the filings of proofs of priority wage claims apprise all parties of the total amounts, including distributions of withholding taxes, that may be payable on account of those claims: withholding taxes are payable out of the employees' distributive share and do not further reduce the amounts available for payment to other creditors. And the trustee and the employees need not be additionally apprised, through the filing of proofs of withholding tax claims, of a duty to withhold that is already prescribed by statute. Thus the court of appeals below was correct in observing (A. 16a):

> The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities.

Our argument is not, as petitioner assumes (Br. 12), that proofs of claims may be "constructively" filed; to the contrary, as we have shown above (pp. 27–31, *supra*), no filings of such proofs are required at all. But the point here is simply that filings of such proofs would in any event serve no purpose under the Bankruptcy Act.

Moreover, the filings of proofs of claims for withholding taxes on priority wage claims is not practicable. Petitioner apparently acknowledges (Br. 11) that proofs of claims for such taxes could not be filed within the six-month period prescribed by Section 57n. At a minimum, such proofs would have to state the total amount of priority wage claims outstanding, and that figure cannot be known until after the close of the six-month filing period. In addition, the tax claims themselves are not computable before the order allowing wage payments is entered by the referee: determination of the tax requires knowledge of both the effective rates of tax and the amount of actual wage payments.[13] Petitioner suggests (Br. 11) that these practical difficulties could be surmounted by having the referee grant extensions of time for filing the proofs. But since the tax is not computable until the wage payments are ordered, an extension to and

[13] Since the effective rates of tax cannot be finally determined until the wage payments are made, petitioner errs in contending (Br. 11) that the government could, at the expiration of the six-month filing period, "compute the total maximum amount of taxes that would be involved." In any event, since the taxes are ultimately payable out of the employees' shares, it is difficult to see in what way a preliminary maximum tax computation would be relevant to the trustee's performance of his administrative responsibilities.

including the date of the order of payment would be required; petitioner's suggestion that such an extension would be acceptable is thus tantamount to an admission that the filing of proofs of such claims is not necessary to bankruptcy administration and would be required, under petitioner's reading of the Act, purely as a matter of form. Furthermore, the granting of such extensions under Section 57n is discretionary with the referee; we see no reason, and petitioner suggests none, why Congress would have imposed a purely formal but mandatory filing requirement upon the government and then left the government's ability to satisfy that requirement dependent upon the discretion of the referee.

In short, the filing requirement petitioner would impose is both impracticable and unnecessary. It is contrary to the plain language of the Act and furthers no legitimate interest of either the creditors, the bankrupt, or the trustee.

III

WITHHOLDING TAXES ON PRIORITY WAGE PAYMENTS ARE FIRST PRIORITY DEBTS UNDER SECTION 64a OF THE BANKRUPTCY ACT

We do not believe that the withholding of federal income and FICA taxes from priority wage payments should ordinarily give rise to any question of priority under Section 64a of the Bankruptcy Act. Section 7501 of the Code imposes upon employers and other persons liable for the collection of taxes a general obligation to hold withholding taxes as "a special fund in trust for the United States." Thus where the

trustee in bankruptcy complies with the command of Section 7501, the withholding taxes are payable as a trust fund to the United States without regard to the priorities established by the Bankruptcy Act. See 3A Collier, *Bankruptcy*, ¶64.02[3]. Cf. *Nicholas* v. *United States, supra*, 384 U.S. at 690–691.

There is, however, no Section 7501 trust fund in this case. Although petitioner has now paid the priority wage claims and withheld the federal income and FICA taxes, this was done pursuant to an agreement, entered into following the court of appeals' decision, that the rights of the parties in this litigation would not thereby be affected. We concede that this agreement bars the United States from contending that petitioner has established a trust fund under Section 7501.

The issue that arises, therefore, is to what priority of payment, if any, the United States is entitled with respect to the withholding taxes in this case. Decision of this issue requires determination of whether the withholding taxes are entitled to one of the priorities granted by Section 64a of the Act: with the exception of secured debts and debts represented by trust funds, debts in bankruptcy are payable only as general unsecured claims unless they fall within one of the five priority categories established by Section 64a.[14]

[14] Only two priority categories are actually at issue here. The parties agree that the third, fourth, and fifth priorities are inapplicable. The district court, following *In re Connecticut Motor Lines, supra*, held that the withholding taxes here are entitled to fourth priority under Section 64a(4) as taxes "which became legally due and owing by the bankrupt." However, as we have shown above (pp. 28–30, *supra*), the withholding taxes on priority wage payments never be-

The positions of the parties, and the decisional authority on which they rely, may be briefly summarized. Petitioner contends (Br. 13–19) that withholding taxes on priority wage payments are not within any of those priority categories and therefore are payable as general unsecured claims.[15] No case authority supports that contention.[16] The City of New York urges (Br. 22–27) that such withholding taxes constitute "wages and commissions" entitled to second-priority treatment under Section 64a(2). No case

come legally due and owing by the bankrupt, only by the estate. Moreover, liability for the withholding taxes here arises only after bankruptcy (see (pp. 28–29, *supra*), whereas Section 64a(4) applies only to taxes that become due prior to bankruptcy. See generally 3A Collier, *Bankruptcy*, ¶ 64.401. These withholding taxes are not even computable prior to bankruptcy (see p. 32, *supra*). Cf. *In re International Match Corporation*, 79 F. 2d 293 (C.A. 2), certiorari denied *sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652. Of course, if this Court concludes, contrary to our contentions, that the withholding taxes here are debts of the bankrupt and that the obligation to pay accrues prior to bankruptcy, those taxes should be accorded fourth-priority treatment. See *In re Connecticut Motor Lines*, *supra*. See generally 3A Collier, *Bankruptcy*, ¶64.405[1].

[15] Underlying petitioner's contention is the assumption that the taxes are debts of the bankrupt, for only "allowed claims" are payable as general unsecured claims under Section 65 of the Act, and only "[d]ebts of the bankrupt" are subject to proof and allowance under Section 63.

[16] Petitioner cites *In re John Horne Company*, 220 F. 2d 33 (C.A. 7), and *Pomper* v. *United States*, 196 F. 2d 211 (C.A. 2), but these cases involved withholding and employer's taxes on wages actually paid prior to bankruptcy. As we have indicated above (pp. 13–14, *supra*), the government recognizes that such taxes are legally due and payable prior to bankruptcy and therefore are entitled only to fourth-priority treatment unless a trust fund has been established pursuant to Section 7501 of the Code. See *United States* v. *Randall*, *supra*.

authority, other than the decision below, supports the City's contention. The United States contends here, as it did below, that the withholding taxes in question are first priority "costs and expenses of administration" under Section 64a(1).[17] This contention finds direct support in the decisions of three courts of appeals. See *United States* v. *Fogarty, supra; United States* v. *Curtis, supra; Lines* v. *California Department of Employment, supra.*

Because withholding taxes on priority wage claims are payable out of the employees' share of the estate, collection and payment of such taxes does not reduce the fund available for distribution to creditors hold-

[17] This issue is properly before the Court. Although the court of appeals rejected the first-priority argument, under its decision the United States would have received full payment of its withholding tax claims, for there are sufficient assets in the estate to satisfy all second-priority claims in full. The United States therefore had no practical basis for seeking further review and for that reason did not file a petition for a writ of certiorari. But petitioner properly recognizes, in both his statements of the questions presented (Pet. 2; Br. 3) and his briefing of the priority issue (Br. 13–19), that this Court necessarily must determine whether the withholding taxes here are excluded from every priority category under Section 64a, including the first priority, in order to decide the issue he raises. For this reason, this case does not present the cross-petition problem of *Strunk* v. *United States*, 412 U.S. 434, *Brennan* v. *Arnheim & Neely, Inc.*, 410 U.S. 512, and *National Labor Relations Board* v. *International Van Lines*, 409 U.S. 48. Moreover, even if the question of first priority were separable from that of nonpriority, which it is not, the first-priority issue in this case would be within this Court's discretionary jurisdiction, especially in view of the fact that our argument on that issue supports the actual asset distribution ordered by the court of appeals. See generally Stern, *When to Cross-Appeal or Cross-Petition—Certainty or Confusion?*, 87 Harv. L. Rev. 763 (1974).

ing lower-priority or general unsecured claims. In this sense, such withholding taxes are analogous to expenses chargeable to funds or parties other than the estate. See 3A Gollier, *Bankruptcy*, ¶ 62.33. Thus no creditors are harmed by payment of the taxes as priority debts: the employees from whose wages the taxes are withheld receive credits for both federal income tax and Social Security purposes (see, *e.g.*, Section 31 of the Code and Section 205(c) of the Social Security Act, 42 U.S.C. 405(c)), and other creditors are left in the same position as if there had been no withholding at all.

In contrast, treatment of such taxes as general unsecured claims would confer an unjustifiable windfall upon other creditors where the estate is insufficient to satisfy all claims: although the United States would be charged with the receipt of the taxes for income tax and Social Security purposes, actual payment of the withheld amounts would be made to other creditors. In this case, for example, due to the insufficiency of the estate, treatment of the withholding taxes as general unsecured claims would result in distribution of the withheld amounts to fourth-priority creditors; nothing would remain for distribution to the United States as a general unsecured creditor. That result is completely unreasonable; it places the United States in a worse position than if there had been no withholding. We therefore believe that treatment of withholding taxes on priority wage payments as nonpriority debts would be both inequitable and irrational. Moreover, as we now show, it is not the treatment accorded by the Bankruptcy Act.

The priority for "costs and expenses of administration" under Section 64a(1) of the Act both applies by its terms to the withholding taxes here and meets the practical needs of bankruptcy administration. The withholding taxes that arise upon payment of priority wage claims in bankruptcy are necessary costs incurred in the course of administering the estate. As such, they fall well within the broad category of "costs and expenses of administration" under the Act. See generally 3A Collier, *Bankruptcy*, ¶ 64.105.

Petitioner's only argument against treatment of the withholding taxes as first priority debts is that "costs and expenses of administration" under Section 64a(1) covers only "the preservation or development of the bankrupt's assets" (Br. 17). This argument is refuted, however, by the genesis and history of that Section, as well as its language. Under Section 64 of the 1898 version of the Bankruptcy Act, the "actual and necessary cost of preserving the estate subsequent to filing the petition" was accorded priority over "the cost of administration." See 3A Collier, *Bankruptcy*, ¶ 64.01[2].[18] But Section 64 was amended in 1938 (52 Stat. 874) and that amendment "grouped [together] all of those claims which arise from the preservation and administration of the bankrupt's estate" into the first priority category. 3A Collier, *Bankruptcy*, ¶ 64.01 [3.1]. And in 1962, that provision was further amended (76 Stat. 571) to make explicit that "costs

[18] *Adair* v. *Bank of America Association*, 303 U.S. 350, upon which petitioner relies, was decided under the 1898 Act; the Court in that case merely observed that since the costs there in question were costs of preserving the estate, they were of course entitled to first priority of payment.

and expenses of administration" embraces, but is not limited to, costs of preserving the estate: Section 64a (1) now reads "the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition * * *".[19] Thus it is now well understood that a wide variety of administrative expenses, bearing no relationship to the preservation of the estate, are entitled to first-priority treatment. See 3A Collier, *Bankruptcy*, ¶ 64.105. In particular, the salaries paid to clerical assistants in connection with validating wage claims and making distributions to claimants, and the mailing expenses incurred in making payment, are administrative expenses entitled to first priority of payment even though they are not costs of preserving the estate. See, *e.g.*, *In re Public Ledger*, 161 F. 2d 762 (C.A. 3). Cf. *Reading Co.* v. *Brown*, *supra*. The withholding taxes that arise upon the payment of those wage claims should be treated in the same manner.

We urge first-priority treatment of such withholding taxes for two reasons: (1) that treatment is the only means of assuring that such taxes will be paid in full; (2) it is, moreover, the only administratively feasible treatment of those taxes. We believe that both these points are illustrated by the following hypothetical.

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[19] "[T]he actual and necessary costs and expenses of preserving the estate subsequent to filing the petition" historically has principally applied to expenses incurred by a receiver in bankruptcy pending adjudication of bankruptcy and appointment of the trustee, whereas the trustee's expenses ordinarily are costs of administration rather than of preservation. See 3A Collier, *Bankruptcy*, ¶ 64.102.

Assume that a trustee in bankruptcy determines that after making allowance for all reasonably foreseeable first priority administrative expenses (excluding withholding taxes on priority wage payments), only $20,000 will remain in the estate, and that priority wage claims in the gross amount of $40,000 have been validated; assume further that the trustee chooses to withhold federal income and FICA taxes at the combined flat rate of 25 percent. Under these assumptions, *pro rata* distribution of the wage claims and collection and payment of the withholding taxes is extremely simple if the taxes are accorded first-priority treatment: each second-priority wage claim will be entitled to a 50 percent payment; thus the claims will be satisfied in the gross amount of $20,000, consisting of $15,000 net wages and $5,000 withholding taxes; the withholding taxes will be payable in full as first-priority debts. In contrast, according withholding taxes only a second priority would complicate the distribution process considerably and result in nonpayment of a portion of the taxes: the wage claims would initially be satisfied in the gross amount of $20,000, consisting, as before, of $15,000 net wages and $5,000 withholding taxes; but the withholding taxes, as second-priority debts, would be entitled only to a 50 percent distribution of $2,500; this would leave $2,500 in the estate to be distributed *pro rata* among second-priority claimants asserting debts of $22,500 ($20,000 of unsatisfied wage claims and $2,500 of unpaid withholding taxes); thus a second distribution of approximately 11.1 percent would be required; under the second distribution gross wage

payments would be made in the approximate amount of $2,222, consisting of $1,667 net wages and $555 withholding taxes; however, of the total withholding tax claim of $3,055 ($2,500 left unpaid from the first distribution and $555 arising upon the second), only $339 (11.1 percent) would actually be paid; thus the total amount actually distributed in the second round of distributions would be $2,006 ($1,667 net wages plus $339 withholding taxes), leaving $494 in the estate still to be distributed among claimants asserting second-priority debts in the aggregate amount of $20,494 ($17,778 of unsatisfied wage claims and $2,716 of unsatisfied withholding tax claims); and so, additional distributions would be required in a decreasing but infinite series that could be accurately expressed only by algebraic formula. The approximate working out of this hypothetical is summarized in the following table:

	Treatment of withholding taxes	
	First priority	Second priority
Amount actually available for distribution	$20,000	$20,000
Wage distributions:		
Gross wages	20,000	22,767
Less: withholding taxes	5,000	5,692
Net wages	15,000	17,075
Withholding tax payments	5,000	2,925
Total distributions	20,000	20,000
Net Unsatisfied Withholding Tax Liability	0	2,767

We do not believe that bankruptcy administration was intended to be burdened by the complex calculations that would be necessary if withholding taxes on priority wage payments were themselves treated as second-priority debts. Nor do we believe that the effective redistribution of withheld amounts to employees that would result from such treatment accords with the purpose and intent of the withholding provisions of the Internal Revenue Code.[20]

In our response to the petition for a writ of certiorari, we also argued for first-priority treatment on the ground that "after the distribution of wages, but before payment of the taxes, the estate may incur other administrative expenses which [otherwise] would have priority over such taxes" (Memo. 7–8, n. 7). Upon further consideration we have concluded that although this argument is technically correct, subsequently incurred administrative expenses are in fact unlikely to result in nonpayment of accrued withholding taxes. A conscientious and responsible trustee, before securing an order for distribution to lower-priority claimants, will set aside sufficient funds to satisfy all reasonably foreseeable administrative expenses. Moreover, contrary to the contention of the City of New York (Br. 27), this common proce-

[20] We acknowledge that these difficulties arise only when there are sufficient funds to pay only a portion of the second-priority wage claims. In other circumstances it should make no difference whether the withholding taxes are paid as first-priority or second-priority debts. If there are ample assets in the estate to satisfy all second-priority claims, the taxes will be paid in full under either priority category. And if the assets are insufficient to make payment of any second-priority debts, the taxes will never arise (see pp. 28–29, *supra*).

dure does not involve "an insoluble mathematical problem" where—as has long been the case in the Sixth, Eighth, and Ninth Circuits—withholding taxes on priority wage payments are treated as first-priority debts. Indeed, the "problem," if any, that is posed in this connection by such withholding taxes is considerably simpler than that posed by ordinary administrative expenses, such as the salaries of clerical assistants. Those other expenses must at least be estimated for the purpose of setting aside a reserve fund, whereas the trustee may safely ignore withholding taxes for that purpose because such taxes only arise upon payment of the wage claims (pp. 28–29, *supra*) and are payable out of the employees' gross share of the estate.

This close relationship between the wage claims and the withholding taxes lends a superficial appeal to the contention of the City of New York (Br. 23–27) that the taxes should be treated as second-priority debts. But, as we have shown, such second-priority treatment is unsatisfactory both from the viewpoint of effective federal tax collection and that of efficient and sensible administration of estates in bankruptcy. Moreover, that treatment would require a somewhat strained reading of the statute. Section 64a(2) of the Bankruptcy Act creates a priority for "wages and commissions * * * due to workmen." Certainly the employees' gross wage claims, encompassing amounts to be withheld as taxes, are claims for "wages" under that provision. But it is the character of the United States' claims that is here in question. Those claims are not

for "wages * * * due to workmen" but for taxes due under Sections 3402 and 3101 of the Code. Cf. *Joint Industry Board* v. *United States, supra*; *United States* v. *Embassy Restaurant, supra.* Those claims do in a sense derive from the wage claims, but they are statutorily-based and have a separate and distinct legal status of their own; there is nothing strange, anomalous, or illogical about giving due recognition to that separate status under the Bankruptcy Act. To the contrary, it is only by recognition of their status as first-priority administrative expenses that the Act can be equitably and efficiently administered.

CONCLUSION

The judgment of the court of appeals should be affirmed insofar as it holds (1) that petitioner must withhold federal income and FICA taxes from payment of wage claims made under Section 64a(2) of the Bankruptcy Act and prepare and submit to the wage claimants and the Internal Revenue Service appropriate information reports and returns with respect to the amounts withheld and (2) that the United States is not required to file a proof of claim with respect to such withholding taxes. The judgment of the court of appeals should be modified insofar as it holds that such withholding taxes are payable as

second-priority rather than first-priority debts under Section 64a of the Act.

Respectfully submitted.

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(Slip Opinion)

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

OTTE, TRUSTEE IN BANKRUPTCY *v.* UNITED STATES ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 73-375. Argued October 15, 1974—Decided November 19, 1974

1. A trustee in bankruptcy for an employer is required by the withholding provisions of the Internal Revenue Code of 1954 (IRC) and similar provisions of the New York City Administrative Code to withhold taxes from the payment of priority claims for wages earned by employees prior to the employer's bankruptcy, but unpaid at the inception of the bankruptcy proceeding. Pp. 5–9.

(a) The payment of the wage claims is "payment of wages" under IRC § 3402 (a), which requires "[e]very employer making payment of wages" to "deduct and withhold upon such wages" an income tax. The facts that the employees' services were performed for the bankrupt rather than for the trustee, and that payment is made after the employment relationship terminated, do not convert the remuneration into something other than "wages" as defined by IRC § 3401 (a) to include "all remuneration." Pp. 5–7.

(b) That in bankruptcy payment of wage claims is effected by one other than the bankrupt former employer does not defeat any withholding requirement, since, although IRC § 3402 (a) refers to the "employer making payment of wages," § 3401 (d)(1) provides that if the person for whom the services were performed by the employee "does not have control of the payment of the wages for such services," the term "employer" then means "the person having control of the payment of such wages." It need not be determined whether it is the trustee, the referee, or the estate that has "control of the payment of such wages" within the meaning of § 3401 (d)(1), since one of them is the "employer" and, as such, has the duty to withhold or to order the withholding, as the case

Syllabus

may be, so that an "employer" under § 3402 (a) is thus present. Pp. 7–8.

(c) So, too, with respect to social security withholding taxes, payments of the wage claims clearly are "wages" under IRC § 3102 (a), which requires the employer to collect such taxes by deducting them "from the wages as and when paid." That the social security withholding provisions of the IRC do not define "employer" is immaterial, for that term is not to be construed more narrowly for social security withholding than for income tax withholding. P. 8.

(d) Because the terms "wages" and "employer" are given the same meanings in the withholding provisions of the City Code as they have in the IRC, the same rationale applies to require withholding of the New York City income tax. P. 8.

(e) Obligating the trustee to withhold does not impose a penalty barred by § 57j of the Bankruptcy Act, since IRC § 6672 and similar City Code provisions, all of which impose a penalty, apart from the tax, on a person who willfully fails to fulfill his obligation to withhold or who willfully attempts to evade or defeat any tax, do not apply in this case. Pp. 8–9.

2. From the obligation to withhold it follows that the trustee is also required to prepare and submit to the wage claimants and to the taxing authorities the reports and returns required of employers under IRC §§ 6051 (a), 6001, and 6011 and similar provisions of the City Code. P. 9.

3. Requiring the trustee to withhold, report, and file returns does not unduly burden the administration of bankrupt estates so as to contravene the spirit of the Bankruptcy Act, for the burden is the same as any employer, or receiver, arrangement debtor, or other fiduciary, with a like number of employees must bear; moreover, both the IRC and the City Code allow the trustee to withhold taxes at a flat rate, thus facilitating the tax computation. Pp. 9–11.

4. Proofs of claim by the United States and New York City with respect to the withholding taxes on the priority wage claims are not required. Since tax liability accrues only when the wage is paid, and since the wages subject to the wage claims here, although earned before bankruptcy, were not paid prior thereto, so that the bankrupt employer's tax liability came into being only during bankruptcy, the taxes are not like debts of the bankrupt for which proofs of claims must be filed. Pp. 11–12.

Syllabus

5. The federal and city withholding taxes are entitled, as are the priority wage claims from which they emerge, to second priority of payment under § 64a (2) of the Bankruptcy Act. Such taxes are not within the fourth priority under § 64a (4), since they did not become due and owing by the bankrupt but only after the wage claims were paid following bankruptcy. Nor are such taxes entitled to first priority under § 64a (1), since they are not costs or expenses of administration of the bankrupt estate, but are part of the wage claims themselves and are carved out of the payment of those claims. Pp. 12–15.

480 F. 2d 184, affirmed.

BLACKMUN, J., delivered the opinion for a unanimous Court.

SUPREME COURT OF THE UNITED STATES

No. 73-375

William Otte, Trustee in Bankruptcy of Freedomland, Inc., Petitioner, *v.* United States and the City of New York.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

[November 19, 1974]

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This bankruptcy case raises issues (a) as to whether priority claims for wages earned by employees prior to an employer's bankruptcy, but unpaid at the inception of the bankruptcy proceeding, are subject to withholding taxes, and, if so, (b) as to whether the taxing entities must file proofs of claim, and (c) as to which priority of payment, if any, the withholding taxes enjoy under § 64 (a) of the Bankruptcy Act (the Act), 11 U. S. C. § 104 (a).[1]

[1] "§ 104. Debts which have priority.

"(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition . . . . (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen. . . . (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy . . . ."

I

On September 15, 1964, Freedomland, Inc., a New York corporation, filed a petition with the United States District Court for the Southern District of New York for an arrangement under Chapter XI of the Act, 11 U. S. C. §§ 701–799. The arrangement failed, and on August 30, 1965, Freedomland was adjudicated a bankrupt. Petitioner William Otte was appointed and qualified as the trustee.

During the statutorily prescribed six-month period for the filing of proofs of claim against the estate, see §§ 57 and 63 of the Act, 11 U. S. C. §§ 93 and 103, 413 former employees of Freedomland filed proofs for unpaid wages (each claim in the amount of $600 or less and all the claims aggregating approximately $80,000) that had been earned within three months preceding the filing of the Chapter XI petition. These wage claims concededly were entitled to a second priority of payment under § 64 (a). No proofs for any federal income or Federal Insurance Contributions Act taxes on these wage claims, withholdable under Chapters 24 and 21, respectively, of the Internal Revenue Code of 1954, 26 U. S. C. §§ 3401–3404 and 3101–3126, were filed by the United States, and no proofs for any New York City personal income tax, withholdable under Chapter 46, Titles T and U, of the New York City Administrative Code, were filed by the city.

In November 1969 the trustee filed a motion for an order directing distribution to the 413 priority wage claimants without deduction for any federal, state, or city withholding taxes. He also asked that the referee declare that the trustee was not required to withhold or pay any such tax or to file any report or return relative thereto with the respective taxing authorities. The State of New York, although served, filed no response to the

trustee's motion. The United States and the city did respond. The referee issued an order granting the trustee the relief he requested. App. 48a–50a. In a supporting memorandum decision, the referee stated that the withholding and reporting requirements of the federal and city statutes "would impose a further burden on the administration of these estates which is entirely inconsistent with the objective of efficient expeditious economic administration of bankrupt estates," and that "compliance with withholding and reporting requirements . . . is utterly inconsistent with the spirit and the letter of the Bankruptcy Act." *Id.*, at 36a–37a.

The United States and the city filed petitions with the United States District Court to review the referee's order and decision. After a hearing, the District Court reversed the order and decision insofar as they pertained to federal taxes. It directed the withholding of federal taxes on the priority wage claims, and also concluded that the amounts to be withheld were "taxes which became legally due and owing by the bankrupt," within the language of § 64 (a)(4), and, therefore, were to be paid as tax claims of the *fourth* priority. The court observed that little more than a simple bookkeeping effort would be involved in withholding 25% of the wage distributions.[2] It held that proofs of claim were not required because the employees' proofs gave notice to the trustee and other creditors of the total amounts distributable on account of the claims. The District Court, however, ruled against the city on the ground that the city's personal income tax did not become effective until 1966,

[2] Under Internal Revenue Service directives, a trustee in bankruptcy, upon paying priority wage claims, has the option of withholding income and FICA taxes either at a combined flat rate of 25% or at the rates prescribed by §§ 3101 and 3402 of the Code, 26 U. S. C. §§ 3101 and 3402.

and thus no city tax was due and owing by the bankrupt in 1964 when the Chapter XI petition was filed. *In re Freedomland, Inc.*, 341 F. Supp. 647 (SDNY 1972).

The trustee, the United States, and the city all appealed. The United States Court of Appeals for the Second Circuit affirmed in part and reversed in part. It held that the trustee was obligated to withhold, to report, and to pay over the withholding taxes on the wage claims, and that the taxing entities were not required to file proofs of claim. It further held, however—and thus to this extent disagreed with the District Court—that both the United States and the city were entitled to be paid as *second* priority claimants under § 64 (a)(2). *In re Freedomland, Inc.*, 480 F. 2d 184 (CA2 1973).

We granted the trustee's petition for certiorari (unopposed by the United States) primarily because the circuits are in disarray as to the priority to be accorded to withholding taxes on prebankruptcy wage claims.[3] 414 U. S. 1156 (1974). No cross-petition was filed by either the United States or the city of New York.

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[3] First priority:

United States v. *Fogarty*, 164 F. 2d 26, 33 (CA8 1947); *Lines* v. *State of California, Dept. of Employment*, 242 F. 2d 201, 203, 246 F. 2d 70 (CA9), cert. denied, 355 U. S. 857 (1957).

Second priority:

In re Freedomland, Inc., 480 F. 2d 184, 190 (CA2 1973).

Fourth priority:

In re Connecticut Motor Lines, Inc., 336 F. 2d 96, 102–106, 108 (CA3 1964).

In *In re John Horne Co.*, 220 F. 2d 33, 35 (CA7 1955), a case concerning wages paid prior to bankruptcy, the court stated, "We are not impressed with the reasoning of the court in the Fogarty case." See also, Note, 56 Mich. L. Rev. 631 (1958); Comment, Bankruptcy—Priorities—Fourth Priority Assigned Payroll Taxes on Second Priority Wages, 40 N. Y. U. L. Rev. 360 (1965); Note, 19 Rutgers L. Rev. 546 (1965).

II

Withholding, Reports, and Returns

Every Court of Appeals which has faced the issue, including the Second Circuit in the present case, has held, contrary to the ruling of the referee, that the withholding provisions of the Internal Revenue Code, and of state or municipal tax statutes, require that a trustee in bankruptcy withhold income and social security taxes from payments of wage claims, and that he prepare and submit to the wage claimants and to the taxing authorities the reports and returns statutorily required of employers. *United States* v. *Fogarty*, 164 F. 2d 26, 30–33 (CA8 1947); *United States* v. *Curtis*, 178 F. 2d 268, 269 (CA6 1949), cert. denied, 339 U. S. 965 (1950); *Lines* v. *State of California, Dept. of Employment*, 242 F. 2d 201, 202, 246 F. 2d 70 (CA9), cert. denied, 355 U. S. 857 (1957); *In re Connecticut Motor Lines, Inc.*, 336 F. 2d 96 (CA3 1964). To the same effect is *In re Daigle*, 111 F. Supp. 109, 111 (Me. 1953).

A. The requirement of withholding. Section 3402 (a) of the Internal Revenue Code, 26 U. S. C. § 3402 (a), requires "[e]very employer making payment of wages" to "deduct and withhold upon such wages . . . a tax determined . . . ." Section 3401 (a) defines "wages" for withholding purposes to mean, with certain exceptions, "all remuneration . . . for services performed by an employee for his employer," and § 3401 (d) defines "employer" as "the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person." The latter section makes an exception where "the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services"; in that case, "employer" means "the person having control of the payment of such wages." Sections T46–51.0 (a) and U46–8.0 of

the New York City Administrative Code are generally to same effect.[4]

The trustee contends that the payment of wage claims under the Bankruptcy Act, although for "wages" within the meaning of that Act, is not the "payment of wages" under § 3402 (a), and that, in any event, the trustee is not the wage claimant's "employer" to whom § 3402 (a) relates.

The payments to the wage claimants who filed in this case are payments for services performed by them for their former employer, Freedomland, before the commencement of the proceeding under the Act. There is, and can be, no dispute as to this. The fact that the services were performed for the bankrupt, rather than for the trustee, and the fact that payment is made after the employment relationship terminated, do not convert the remuneration into something other than "wages," as defined by § 3401 (a) of the Internal Revenue Code. That statute, as has been noted, broadly defines "wages" to include, with stated exceptions not material here, "all remuneration." And § 3401 (d), in defining "employer," twice refers to services that the employee "performs or performed." It thus speaks in the past tense as well as the present and thereby plainly reveals that a continuing employment relationship is not a prerequisite for a payment's qualification as "wages." The income tax withholding regulations since 1943 have so provided in specific terms. 26 CFR § 31.3401 (a)–1 (a)(5) (1974); Treas. Reg. 120 § 406.205 (b) (1954); Treas. Reg. 116 § 405.105 (1944 and 1951 eds.); Treas. Reg. 115 § 404.-101 (a) (1943). The regulations are not in conflict with

[4] The terms "wages" and "employer," as they appear in Titles T and U of the City Code are given the same meanings they have in the Internal Revenue Code. New York City Administrative Code, §§ T46–1.0 (e) and U46–1.0 (b), (e) and (*l*).

the statute; they further the statutory purpose and are reasonable; and they are a valid exercise of the rule-making power. *Cammarano* v. *United States*, 358 U. S. 498, 507–512 (1959).[5]

The payment of the wage claims is thus "payment of wages" under § 3402 (a) of the Internal Revenue Code.

The fact that in bankruptcy payment of wage claims is effected by one other than the bankrupt former employer does not defeat any withholding requirement. Although § 3402 (a) refers to the "employer making payment of wages," § 3401 (d)(1), as also has been noted, provides that if the person for whom the services were performed "does not have control of the payment of the wages for such services," the term "employer" then means "the person having control of the payment of such wages." This obviously was intended to place responsibility for withholding at the point of control. The petitioner trustee suggests that control rests in the referee rather than in the trustee, because of the former's duty, under § 39 (a)(5) of the Act, 11 U. S. C. § 67 (a)(5), to "declare dividends." We need not determine whether it is the trustee, with his responsibility, under §§ 47 (a)(8) and (11) of the Act, 11 U. S. C. §§ 75 (a)(8) and (11), for making recommendations and actual payments, or the referee, with his supervision over the general administration of the bankrupt estate, or the estate itself, that has "control of the payment of such wages," within the meaning of § 3401 (d)(1) of the Internal Revenue

[5] We see nothing to the contrary in *United States* v. *Embassy Restaurant, Inc.*, 359 U. S. 29 (1959), which is pressed upon us by the trustee. The issue there was whether contributions by an employer to a union welfare fund, as required under a collective-bargaining agreement, were entitled to second priority as "wages . . . due to workmen." There is no such issue here, for the trustee acknowledges, as he must, that the present claims are, indeed, for "wages," within the meaning of the Bankruptcy Act.

Code. One of them is the "employer" and, as such, has the duty to withhold or to order the withholding, as the case may be.[6] An "employer," under § 3402 (a), is thus present.

The situation is the same with respect to FICA withholding. Section 3102 (a) of the Internal Revenue Code, 26 U. S. C. § 3102 (a), provides that the tax is to be collected by the employer by deducting "from the wages as and when paid." Here, too, the payments clearly are "wages" under that statute, even though again, at the time of payment, the employment relationship between the bankrupt and the claimant no longer exists. And here, also, the regulations long and consistently have been to this effect. 26 CFR § 31.3121 (a)–1 (i) (1974); Treas. Reg. 128 § 408.226 (a) (1951); Treas. Reg. 106 § 402.227 (a) (1940). The fact that the FICA withholding provisions of the Code do not define "employer" is of no significance, for that term is not to be given a narrower construction for FICA withholding than for income tax withholding.

Because of the identity of definition already observed, n. 4, *supra*, the same rationale necessarily applies to the New York City withholding tax.

The trustee finally suggests that the placing of a withholding obligation upon the trustee amounts to the imposition of a penalty barred by § 57 (j) of the Act, 11 U. S. C. § 93 (j). This argument, however, rests upon the presence of § 6672 of the Internal Revenue Code, 26 U. S. C. § 6672, and §§ T46–65.0 (g) and U46–35.0 (g) of the New York City Administrative Code, all of which impose a penalty, apart from the tax, on a per-

[6] "The result would be no different if it is argued that the bankruptcy court rather than its trustee is 'the person having control of the payment of such wages.' There is no provision excepting a court from the requirement of withholding on amounts paid an employee." *United States* v. *Fogarty*, *supra*, 164 F. 2d, at 32.

son who willfully fails to fulfill his obligation to withhold or who willfully attempts to evade or defeat any tax. That, obviously, is not this case.

B. The requirement of reports and returns. This routinely follows from the obligation to withhold. Section 6051 (a) of the Internal Revenue Code, 26 U. S. C. § 6051 (a), provides that a person required to withhold must furnish the employee a written statement showing the wages subject to withholding and the amount withheld on account of each tax. A duplicate of that statement is to be available for filing with the Internal Revenue Service. § 6051 (d). Sections 6001 and 6011 require every person responsible for payment or collection of tax to keep such records and make such returns as the Secretary prescribes. The applicable regulations respond to these statutes. 26 CFR §§ 31.6001–1, 31.6001–2, 31.6001–5, 31.6011 (a)–6 (a)(1), and 31.6051–1 (1974); Rev. Proc. 71–18, 1971–1 Cum. Bull. 684. It is undisputed that the petitioner trustee must comply with these provisions if he is subject to the withholding requirements of §§ 3402 and 3102. *Nicholas* v. *United States*, 384 U. S. 678, 693 (1966).

The New York City Administrative Code provisions are of similar effect, §§ T46–52.0 and T46–54.0, U46–9.0 and U46–11.0, and we reach the same conclusions with respect to reports and returns thereunder.

C. Expense and delay. The trustee argues, as the referee held, that the imposition of obligations to withhold, report, and file returns places a burden on the administration of bankrupt estates that is at odds with economic and expeditious administration and with the spirit of the Act. He places some reliance, as did the referee, on the paper by referee R. L. Hiller, "The Folly of the Fogarty Case," 32 J. Nat. Assn. Refs. in Bank. 54 (1958), where the author states that "the application of the Fogarty

rule is sheer nonsense" and that the case is "out of harmony with sound bankruptcy law." *Id.*, at 54, 56.

There is, of course, an overriding concern in the Act with keeping fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors. 3A Collier on Bankruptcy ¶¶ 62.05 [1], 62.02 [5] (14th ed.). And it cannot be denied that paperwork takes time and occasions expense. In this particular case, withholding must be computed on the 413 wage claims, returns (Forms W–2, W–3, and 941) must be prepared and furnished the claimant and the Internal Revenue Service, records must be maintained, and the taxes withheld must be remitted to the respective taxing entities.

We are not persuaded, however, that this burden would be so undue as to be inconsistent with or violative of the spirit of the Act. It is the same burden, no more and no less, that any employer of the same size must bear, and it is the same burden that is borne by any receiver or arrangement debtor or any other fiduciary with a like number of employees. The burden is not disproportionate.[7] Further, the Internal Revenue Service has endeavored to lighten the load by its alternative 25% combined bankruptcy withholding rate for income and FICA taxes. See n. 2, *supra*. New York City has done the same with its 1% withholding rate. Neither should the burden make it necessary, as is so often and so easily suggested, to employ an accountant. Computations at the rates of 25% and 1%, respectively, are simple and elementary arithmetic exercises, hardly worthy of an accountant's

[7] The District Court, on review of the referee's order and decision, received evidence with respect to costs of compliance. It concluded that compliance "adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment." 341 F. Supp., at 654.

talent; a high school student is able to make those computations as is any bookkeeper, clerk, or the trustee himself. The added tasks of withholding, reporting, returning, and remitting are contemplated, in our view, by the Act. The interests of the taxing entities, who are creditors, too, and, through them, the interests of the public, outweigh the miniscule added burden for the estate. See *Swarts* v. *Hammer*, 194 U. S. 441, 444 (1904). If relief is to be considered for bankrupt estates in this respect, it is a matter for legislative, not judicial, concern. There is nothing in the Act or in the Internal Revenue Code that relieves the trustee of these duties. Cf. §§ 7507, 108 (b), 371, and 372 of the Internal Revenue Code, 26 U. S. C. §§ 7507, 108 (b), 371, and 372.

III

Proofs of Claim

The trustee asserts that because the United States and the city failed to file proofs of claim for the taxes at issue, payment thereof is barred. It is said that these taxing entities were on notice, by reason of Freedomland's bankruptcy schedules, that the bankrupt owed the priority wage claims; that these claims were to be filed within six months; that the entities could obtain an extension of time, under § 57 (n) of the Act, 11 U. S. C. § 93 (n), in which to compute and file their claims; and that they chose to ignore the referee's bar order directed, among others, to "taxing authorities and agencies," App. 24a.

This argument, in our view, misconceives the nature of the taxes that are to be withheld. Liability for the taxes accrues only when the wage is paid. Sections 3402 (a) and 3101 (a) of the 1954 Code; New York City Administrative Code, §§ T46–51.0 (a) and U46–8.0. The wages that are the subject of the wage claims, although earned before bankruptcy, were not paid prior to bank-

ruptcy. Freedomland had incurred no liability for the taxes. Liability came into being only during bankruptcy. The taxes do not partake, therefore, of the nature of debts of the bankrupt for which proofs of claims must be filed.

Furthermore, the filing of proofs by the United States and New York City obviously would serve no purpose here. Proofs apprise the trustee and other creditors of the existence of claims against the estate. The priority wage claims themselves, however, cover the gross wages earned and unpaid. These include any tax that is to be withheld. The tax is not an added increment.

We conclude, therefore, that proofs of claim on the part of the United States and of New York City with respect to withholding taxes on priority wage claims are not required.

IV

With withholding taxes thus determined as properly applicable to priority wage claims, their placement in the payment scale under § 64 (a) must be determined.[8] The choice lies between the first priority (costs and expenses of administration), urged by the United States; the second priority (wages and commissions, limited as the statute specifies), urged by the city of New York; the fourth priority ("taxes which became legally due and owing by the bankrupt"), urged by none of the parties

[8] The trustee has paid the priority wage claims, with the taxes withheld and set aside. This was done, however, pursuant to an agreement that the rights of the parties would not be affected thereby. The United States, therefore, is not in a position to claim that a trust fund has been established under § 7501 (a) of the Internal Revenue Code, 26 U. S. C. § 7501 (a). See *United States* v. *Randall*, 401 U. S. 513 (1971); *Nicholas* v. *United States*, 384 U. S. 678, 690–691 (1966).

here; and no priority at all. The third and fifth priorities clearly have no possible application to these taxes.

We readily reject the fourth priority. The withholding taxes are not taxes which became due and owing by the bankrupt. As has been noted above, the taxes did not become due and owing at all until the claims, constituting wages, were paid. This took place after bankruptcy, not before. The situation, thus, differs from that where the bankrupt paid wages prior to bankruptcy, but the taxes withheld were not remitted to the taxing entities by the time of the inception of the bankruptcy proceeding. The latter would be taxes "which became legally due and owing by the bankrupt." See *In re John Horne Co.*, 220 F. 2d 33 (CA7 1955); *Pomper* v. *United States*, 196 F. 2d 211 (CA2 1952).

We similarly reject the first priority, although we recognize that this appears to be the favorite conclusion reached by those courts that have passed upon the issue. See n. 3, *supra*. The leading case for this approach is *United States* v. *Fogarty*, *supra*. The Court there, however, without a statement of underlying reasons, merely concluded that the taxes "should be allowed and classified as an expense of administration," 164 F. 2d, at 33. In *Lines* v. *State of California, Dept. of Employment*, *supra*, the court followed *Fogarty* and held that, because the tax accrued "subsequent to the filing of the petition in bankruptcy, such tax had the character of an expense of administration." 246 F. 2d, at 71.

We think that more than a general observation that the taxes arose during bankruptcy is required to dignify withholding taxes with the prime status of first priority. We grant that the very language of § 64 (a)(1) ("including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition")

necessarily indicates that first priority items include some in addition to those that preserve or develop the bankrupt estate. Withholding taxes, however, do not strike us as costs or expenses of doing business. They are attributable in their entirety to the availability of funds for the payment of priority wage claims. They accrue only as those claims are paid and, to the extent of that payment, the payment of the taxes should be assured. In addition, it is anomalous to accord withholding taxes a higher priority than the wage claims to which they so directly relate. They can be computed only upon the amount of funds available for payment of the wage claims and should not have a computational base greater than those payments. The withholding taxes are, in full effect, part of the claims themselves and derive from and are carved out of the payment of those claims. We therefore fully agree with the Second Circuit's observation, 480 F. 2d, at 190: "Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part."

We see nothing in *United States* v. *Randall*, 401 U. S. 513 (1971), with its observation, at 515, that the Bankruptcy Act "is an overriding statement of federal policy on this question of priorities," that is contrary to the result we reach here. That case concerned § 7501 (a) of the Internal Revenue Code, 26 U. S. C. § 7501 (a), with its provision for a trust fund for withheld taxes, and the impact of that statute, when not complied with, upon payment of first priority costs and expenses of administration. *Randall* is not a holding, as the trustee would claim, Brief for Petitioner 18–19, that the withholding taxes do not have the same priority as the wage claims themselves.

We therefore conclude that these federal and city withholding taxes are entitled, as are the priority wage claims

from which they emerge, to second priority of payment under § 64 (a) of the Act, 11 U. S. C. § 104 (a).[9]

The judgment of the Court of Appeals is affirmed.

It is so ordered.

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[9] This conclusion makes it unnecessary for us to consider whether, if the Government were to prevail in its first priority argument, the judgment of the Court of Appeals here could be modified in the absence of a cross-petition by the United States. We are advised that the bankrupt estate's assets are sufficient to pay all first and second priority claims in full. Tr. of Oral Arg. 28–29. Whether the withholding taxes have first rather than second priority status is, therefore, of no practical consequence to the Government in the present case.